INFORMATION FOR INVESTMENT PROFESSIONALS

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In Credit

7 JUNE 2021

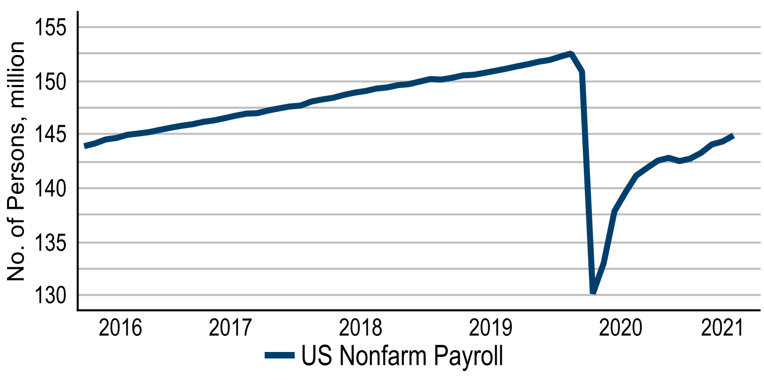
Steady as she goes…

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.58%	-2 bps	0.2%	-3.3%
German Bund 10 year	-0.20%	-2 bps	0.2%	-3.0%
UK Gilt 10 year	0.81%	1 bps	-0.3%	-6.8%
Japan 10 year	0.08%	0 bps	-0.1%	-0.3%
Global Investment Grade	93 bps	1 bps	0.3%	-1.9%
Euro Investment Grade	85 bps	0 bps	0.2%	-0.6%
US Investment Grade	91 bps	1 bps	0.3%	-2.4%
UK Investment Grade	92 bps	-1 bps	0.0%	-3.2%
Asia Investment Grade	208 bps	-2 bps	0.1%	-1.3%
Euro High Yield	304 bps	-4 bps	0.4%	2.7%
US High Yield	328 bps	-1 bps	0.3%	2.6%
Asia High Yield	558 bps	11 bps	-0.5%	1.3%
EM Sovereign	308 bps	1 bps	0.3%	-1.6%
EM Local	4.9%	-1 bps	0.7%	-1.5%
EM Corporate	297 bps	1 bps	0.2%	0.6%
Bloomberg Barclays US Munis	1.0%	-2 bps	0.2%	1.0%
Taxable Munis	2.3%	-2 bps	0.4%	-1.4%
Bloomberg Barclays US MBS	19 bps	3 bps	0.0%	-0.7%
Bloomberg Commodity Index	202.29	2.0%	2.0%	21.3%
EUR	1.2165	-0.2%	-0.5%	-0.4%
JPY	109.29	0.3%	0.0%	-5.7%
GBP	1.4174	-0.2%	-0.4%	3.6%

Source: Bloomberg, Merrill Lynch, as at 7 June 2021.

Chart of the week: US Non-farm Payroll



Source: US BLS, Macrobond, Columbia Threadneedle Investments, as at 7 June 2021.

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Macro / government bonds

We saw some key economic data last week, in what felt like a seasonal lull for a number of European countries given the late May bank holiday and a week of school holidays.

In the UK, sterling hit a three-year high as the country is on track to have fully vaccinated 75% of the population against Covid-19 by the end of June. This comes just in time for the final phase of the restrictions due to be completely lifted on 21 June. Despite zero deaths being announced on Tuesday (the first time this has happened since the beginning of the pandemic), some UK-based scientists are pushing for this deadline to be delayed due to expectations of the Delta variant (formely known the Indian variant), causing a spike in cases in some parts of the country. On a more positive note, UK mortgage approvals rose to 86k in April versus an estimated 81k. This comes as the pace of UK housing prices was at its strongest in seven years. It will be interesting to see what happens as the stamp duty holiday comes to an end this month.

In Europe, plans were revealed to lift all quarantine requirements for citizens who are fully vaccinated or carry proof of a negative test, starting on 1 July. The composite PMI for the eurozone rose to 57.1 in May, up from 53.8 in April, in-line with consensus. We also heard from the EU of $100bn to be raised in long-term bonds and “tens of billions” in short-term securities, later this year, to partly finance the stimulus measures put in place for pandemic support.

Across the pond, the US ISM Manufacturing for May come in at 61.2, vs 61.0 consensus, along with the ISM Services at 64.0, the highest we have seen since records began in 1997. Employment data, out on Friday, didn’t seem to excite the market as much as hoped. Non-farm payrolls were a miss on consensus, rising only by 559k (675k expected). Though an improvement on the 278k increase in April, it still leaves the economy 7.6 million jobs short of pre-pandemic levels **(see Chart of the week).** The unemployment rate fell to 5.8% from 6.1%, just below consensus of 5.9%, but was accompanied by an average hourly earnings increase of 0.5%, which was above the 0.2% rise that was expected.

Investment grade credit

There was very little movement in credit spreads last week with most indices ending the week more-or-less where they started. Global, European and sterling Non-Gilt investment grade credit all remain below 100bps and well below their long-term averages. Issuance was low but is set for a busy week this week as the market makes it’s way to the end of the second quarter.

High yield credit

US high yield bond prices rose over the week amidst a lighter primary calendar, moderating outflows, stable US Treasury yields and data consistent with continued improvement in the global economy. The ICE BofA US HY CP Constrained Index returned 0.33% over the week. Spreads were unchanged at +337bps while the yield-to-worst declined 0.09% to 4.01%. According to Lipper, the asset class reported a $385m outflow over the week. This represents the fifth consecutive weekly outflow, but also the smallest outflow over the period. $6.4bn of weekly new issue volume was the lowest total over the last two months.

European high yield had a quiet but still firm first week of June with spreads 4bps tighter from the previous Friday. Inflows were light at €55m but all due to ETFs. Market was supported by a light week for new issuance with only the £645m and €300m offering by David Lloyd, the gym operator, taking the year-to-date total to €72.2bn.

The Autostrade/Atlantia story is finally coming to a close as shareholders have approved the sale of Atlantia's entire stake in Autostrade to the CDP/Blackstone/Macquarie consortium. In a sign that even with a solid market, investors are being selective, Autodis, a French car parts firm, cancelled its IPO and notified bondholders that the firm will not be redeeming its 2022 bonds, nor part of the 2025 bonds, as previously announced as conditions for redemption have not been met. There are over 50 IPOs waiting in the wings and so far IPOs have not been proceeding as well as expected.

Leveraged loans

Leveraged loan prices were largely unchanged over the week and currently sit at a 2.5 year high of $98.53, referencing the J.P. Morgan Leveraged Loan Index. Yields and spreads (3-year) decreased 1bps and 2bps over the past week to 4.70% and 427bps. The asset class reported its 20th consecutive weekly inflow with a $460m contribution, although the amount was well below the average year-to-date weekly inflow of $800m.

Asian credit

On 3 June 2021, the US government provided more clarity on the scope of the prohibition on investment in Chinese entities. A new Executive Order was announced which amends the Annex of the original Executive Order 13959. A new list which is called the Non-SDN Chinese Military-Industry Complex Companies List (NS-CMIC List) contains 59 entities. This NS-CMIC List will replace and supersede the Non-SDN Communist Chinese Military Companies List (NS-CCMC). The prohibition on purchasing securities of the affected entities will take effect on 2 August 2021 with a one-year period to divest the holdings (from 3 June 2021). For any new entities that are added to the NS-CMIC List in the future, the prohibition on purchase will take place 60 days after the inclusion of the entities on the list. There is a 365-day period after the date of determination for divestment. Positively, the NS-CMIC List excludes certain companies that were on the original NS-CCMC List, such as China National Chemical Corp Ltd (ChemChina), China State Construction Group, China Three Gorges Corp and Sinochem. There is also more clarity now that subsidiaries not publicly listed in the NS-CMIC List, are not affected by investment prohibition.

The Chinese government is reportedly pushing China Huarong Asset Management (HRAM) to sell its non-core assets that include a bank, investment company and a consumer finance company (source: Bloomberg). Without commenting about the asset sales, HRAM stated that the regulators is pushing it to focus on its main businesses and build up its core competitiveness.

Emerging markets

In Mexico, it looks like the country's ruling coalition has lost its super-majority with last weekend's mid-term elections. This means it will be harder for them to pass legislative changes. The peso rallied on the news as it's expected this will provide a check on the party's power.
In Peru, early voting counts show presidential candidates Castillo and Fujimori are neck and neck after the weekend's elections, though Fujimori still leads in the polls. Markets have been selling off following any positive news from Castillo's campaign. Investors are sceptical on proposed higher taxes for mining companies; Peru is one of the largest copper producers in the world.

Despite having one of the worst Covid outbreaks, India is now planning on easing restrictions in some states. In one state, Maharashtra, from 7 June, malls, cinemas, restaurants, and offices will be allowed to open in areas with a positivity rate below 5%.

On the issuance front, Saudi Aramco is looking to issue up to $5bn worth of US dollar denominated Sukuk bonds. This comes despite the fact that the company paid a $75bn dividend last year.

Commodities

Energy markets were amongst the best performers over last week, rallying 4.2%, overall. Brent climbed 4.6% as Iran and western powers failed to reach a deal to alleviate sanctions, thus allowing Iran to continue to sell more barrels into the market.

Soybean oil rallied 8.4%. The rally has been driven by the ongoing vegetable oil shortage. The demand for vegetable oils comes on the back of both government net zero 2050 emissions targets and a reduced supply of "waste oils" as a consequence of lower restaurant and catering trade.

In agriculture, spring wheat rallied between 3.7% (in the Chicago contracts) and 11.7% (in the Minneapolis contracts.) The rally has been weather driven, specifically due to dryness in the former soviet bloc countries.

Responsible Investments

Over the weekend, along with a global tax reform agreement, the G7 decided on a number of measures to crack down on environmental crime, disclosing climate data along with numerous other key steps towards the global financial system playing its part in becoming net zero. Climate disclosures will be mandatory across their respective economies, just six months after the UK became the first country in the world to do so in November 2020.

JP Morgan ranks as the leading underwriter of green bond sales globally, ahead of both BNP Paribas and Citigroup. At almost triple last year's pace, green bond sales approached nearly $200bn in issuance year-to-date at the end of May.

Part of the previously mentioned issuance from the EU will be used to fund green-related projects.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

7th June 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 data is shaping up to be noisy once again, but in a much different way than 2020. This time, growth is going to be robust, especially in the US. In addition, issuers on the whole are coming into this environment with better liquidity than before the pandemic. ▪ Valuations in most areas of credit provide much less cushion for volatility. But compared to similar spread levels in the decelerating global economy pre-COVID, we still prefer to carry more credit risk in today's accelerating economy. ▪ Question marks on the sustainability of super easy financial conditions, inflation, & central bank reaction functions do increase uncertainty.	▪ 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 ▪ Geopolitical tensions rise above a simmer, particularly in the US and Russia or China
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long £ €	▪ 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	▪ 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 Short -2 -1 0 +1 +2 Long E A$ $	▪ 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 ▪ US fiscal push fades
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	▪ 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, leading to higher EM inflation via fx ▪ EM funding crises drive curves higher and steeper
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Political risk is rising at the same time as the pandemic is surging in many large EM's. There are several Latam elections this year with a wide array of possible outcomes, and worsening COVID and low growth is central to them. ▪ Index composition changes over the last 5 years have added a lot of duration to the sector, leaving it vulnerable. ▪ US growth outperformance is starting to cause weakness in EMFX, and financial conditions for EMs is tightening.	▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Index spreads are back to pre-COVID levels, but the duration of US indices have also lengthened by ~10%. ▪ Issuer balance sheets still look remarkably strong, and cash reserves remain very high. Our base case is that a fair amount of deleveraging can occur with this cash, but as the economic recovery accelerates and COVID moves to the rear-view mirror, the spectre of M&A and shareholder return still looms. ▪ IG has been historically resilient in the face of inflation, even if other sectors may benefit more from it.	▪ 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 spreads are still wider than pre-COVID. ▪ Access to capital remains easy even through more volatile markets of late, and a return to normalcy disproportionately benefits low-quality credits. ▪ 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, 2020's downgrade cycle turns quickly into an upgrade cycle. ▪ 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. ▪ These unattractive technicals may persist if the Fed continues buying. Fed buying cannot be expected to increase in 2021, ultimately exposing negative fundamentals and valuations. ▪ Duration in the sector is now rising quickly as mortgage rates move higher.	▪ 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	▪ 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: favoured bonds are still 'story' bonds. A return to normal won't look 'normal' for sectors like office space or convention hotels ▪ Spread tightening looks somewhat excessive along the margins of credit quality.	▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper & Lead vs Zinc ▪ o/w Soybeans ▪ u/w Livestock ▪ u/w Gold	▪ US China trade war

Important information: For use by Professional and/or Qualified Investors only (not to be used with or passed on to retail clients). Source for all data and information is Bloomberg as at 07.06.2021, unless otherwise stated.

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