

In Credit

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Mamma Mia... here we go again?

Markets at a glance



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	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	2.92%	-1 bps	0.5%	-1.5%
German Bund 10 year	0.40%	0 bps	1.3%	1.1%
UK Gilt 10 year	1.30%	-2 bps	1.1%	0.3%
Japan 10 year	0.05%	1 bps	0.2%	0.5%
Global Investment Grade	120 bps	4 bps	0.2%	-2.1%
Euro Investment Grade	115 bps	6 bps	-0.3%	-0.6%
US Investment Grade	121 bps	5 bps	0.0%	-3.0%
UK Investment Grade	121 bps	4 bps	0.1%	-1.1%
Asia Investment Grade	190 bps	6 bps	0.4%	-1.3%
Euro High Yield	376 bps	16 bps	-0.9%	-0.5%
US High Yield	355 bps	2 bps	0.1%	-0.2%
Asia High Yield	509 bps	27 bps	-1.4%	-3.1%
EM Sovereign	366 bps	17 bps	-1.4%	-4.6%
EM Local	6.4%	-5 bps	-5.0%	-3.7%
EM Corporate	310 bps	10 bps	-0.9%	-2.6%
Bloomberg Barclays US Munis	2.7%	-5 bps	1.1%	-0.4%
Taxable Munis	4.1%	-4 bps	0.6%	-2.4%
Bloomberg Barclays US MBS	27 bps	-1 bps	0.4%	-1.3%
Bloomberg Commodity Index	90.31	-0.5%	1.0%	2.6%
EUR	1.1708	0.1%	-3.5%	-2.9%
JPY	109.61	-0.1%	-0.2%	2.9%
GBP	1.3375	0.3%	-3.0%	-1.2%

Source: Bloomberg, Merrill Lynch, as at 4 June 2018.

Chart of the week: Falling German unemployment rate



Source: Bloomberg, Columbia Threadneedle Investments, May 2018.

Key markets overview

Macro / government bonds

Just as Abba's hit song Mamma Mia reminds us of the 1970s so the price action in fixed income last week was more like 2012 and the Eurozone crisis. The uncertainty about the Italian political outlook sent shock waves through the government and corporate bonds of that country, but also reverberated around all asset classes as risk was repriced and safe haven assets rallied. Italian government bonds had been trading with a yield spread of around 1.1% more than core German bonds a few weeks ago. This spread widened materially to 2.7% at one-point last week before some calm returned and spreads narrowed to around 2.2% at the end of the week. A government has been formed but faces a confidence vote in the next few days. In other political developments Spanish Prime Minister Rajoy was ousted in a vote of no confidence in his party.

There was better news on the data front. The German unemployment rate fell to 5.2% in May, below the consensus of 5.3%. The labour market is tightening quickly, and this brings the risk of higher wage growth, which is further supported by anecdotal evidence from industrial wage settlements. Interesting then that the consumer price inflation rate came in at 2.2% y/y, which was well above the expected 1.8% and the highest rate of inflation since March 2012. French and Spanish data followed the same trajectory rising by 2% y/y and 2.2% y/y respectively. Energy prices were the chief reason for the rise in inflation in the two countries. Deutsche Bank noted that the difference now between German bond yields and inflation is within a whisker of record levels with data going back to the 1950s. For the Eurozone as a whole, inflation grew by 1.9% y/y and almost in line with the ECB's target rate, while unemployment fell to 8.5% from over 9% last year.

In the US, the same employment trend remains in place. The monthly employment report was solid across the board. May payrolls rose by 223k (consensus 190k). The unemployment rate fell to 3.8% and was its lowest level since spring 2000. Meanwhile, average hourly earnings also rose more than expected and by 0.3% m/m to 2.8% y/y.

Investment grade credit

Corporate and high yield spreads have widened this year but the dispersion in market returns geographically has been material. Europe has underperformed – most recently driven by the issues in Italy (see table 1) and high yield has outperformed investment grade in a percentage spread move sense.

Table 1: And the winner is.... the US and High Yield

Credit Market	Spread end 2017	Tight Spread 2018	Latest Spread	Change from tights
Euro Investment Grade	87bps	74bps	115bps	+55%
US Investment Grade	99bps	90bps	121bps	+33%
Euro High Yield	304bps	274bps	376bps	+34%
US High Yield	363bps	323bps	355bps	+10%

Source ICE Bond Indices June 2018.

In the corporate world, bellwether Italian issuers such as Telecom Italia saw its CDS spreads widen from around 130bps in mid-May to around 175bps. In the banking sector, subordinated debt was especially weak. As an example, Intesa's AT1 bonds with a 7.75% coupon and a 2027 call have fallen in price from 128 to 113 over the last three months. Amid the market turbulence the new issuance market has dried up.

US investment grade corporate bonds were not immune to increased market volatility last week. Spreads gapped wider as risk was shed but lower yields 2 years and out led to a marginal positive return of 4bps. Quality led the way with AAA rated bonds greatly outperforming BBB.

It's been a bruising year for investment grade corporate bonds, down more than 3% for the first five months of 2018. The head scratcher continues to be better credit metrics as fundamentals continue to improve. In Q1, 2018, EBITDA and revenue growth both grew at their fastest pace since 2012, led by commodity issuers. And more importantly, cash flow growth has outpaced debt levels, which has positively impacted leverage multiples. Our view is that supply imbalances (less foreign buying and elevated new issue supply expectations), rate and equity market volatility and the myriad of geopolitical concerns are the culprits here.

High yield credit

The pattern of European underperformance is also a feature of the high yield market. As in investment grade it was Italian names that were the weakest and this period of uncertainty has brought the new issue market to a halt. European high yield spreads widened 30bps to highs of 390bps before retracing half of the move wider by the end of the week. Italian cash bonds were down anywhere between 1-4 pts, but overall generic high yield remained relatively insulated from the political noise compared to other asset classes. In corporate news, Shop Direct was up 7pts on the back of benign implications from the FCA's High Cost Review (after the bonds fell as much as 19pts following numbers released the prior week). Samsonite was also 2pts better after the CEO resigned in response to a critical short-seller's report. The asset class returned to outflow.

US high yield bond spreads recovered most of the early week spread widening as Italy managed to form a government and avoided having to call a fresh election. Also driving volatility were headlines surrounding trade relations, speculation OPEC could ease production restraints at its June meeting and a solid payroll report underscoring a US economy strong enough to withstand external events. The asset class reported outflows totalling -\$18m over the week, according to Lipper.

Emerging markets

Emerging markets were not immune to the turbulence and spreads were also wider. The EMBI hard currency index has widened from around 290bps to over 360bps in recent weeks. This takes the spread back to the five-year average (range 270-540bps).

Turkey has started to perform a bit better, however, after a serious devaluation of the Lira and widening of sovereign spreads in the wake of suggestions of more political involvement in the setting of monetary policy. A theme of rising political populism, however, can be seen in Brazil in the response to the truckers' strike and Mexico where the left-wing candidate looks to be in a very strong position ahead of upcoming elections.

Asian fixed income

Asian credit recorded another firm week after renewed concerns surrounding the stability of the Eurozone provided support to US treasury prices though sovereign and corporate spreads were wider.

In investment grade credit, Chinese tech Alibaba strengthened its logistics capabilities with a \$1.38bn investment in ZTO Express. Tencent announced a partnership with Wanda to focus on smart retail, utilizing Tencent's technology and Wanda's commercial property expertise.

In the high yield market state-backed China Reserve Energy missing its principal payment, which caused investors to shun bonds with weaker short-term liquidity and poorer disclosure. In India, Vedanta was ordered to close its Southern India copper smelter after a deadly protest. The primary market produced a modest \$3.9bn of new supply, the majority coming from Chinese property developers.

Commodities

The market was weaker over the last week with WTI oil down by around 3.5% whereas Brent crude rose a little. The difference between these commodity's prices is now around \$11 per barrel. Meanwhile, OPEC announced a production increase to offset disruption in Venezuela.

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"> Strong hard data prints have helped global central banks begin to synchronously turn the page on easy monetary policy. With yields pressing higher, it seems timely to be more cautious on risk assets which remain near cyclical tights. That said the fundamental picture remains strong. With spreads this tight we expect spreads to widen and excess returns to be modest or negative. 	<ul style="list-style-type: none"> Inflation accelerates, 10Y reaches 325Bps and spreads widen dramatically Conversely, oil continues to be supported by OPEC and record demand through '19 and fundamentals improve causing spreads to near all time tights
Duration (10-year) ('P' = Periphery)	<ul style="list-style-type: none"> Moderate o/w US/Australia vs EUR Flattening bias 	<ul style="list-style-type: none"> Evidence of sustainable reflation Renewed ECB stimulus effort Eurozone break-up
Currency ('E' = European Economic Area) 	<ul style="list-style-type: none"> cyclical divergence and short dollar positioning have supported the USD of late, await further clarity on global growth re-convergence before increasing USD short" Deterioration of tw in deficits a USD negative 	<ul style="list-style-type: none"> Curve steepens as market reassesses reflationary impact of tax package Italian politics delays expected ECB tightening
Emerging Markets Local (rates and currency) 	<ul style="list-style-type: none"> Improvement in EM fundamental story Growth in EM is accelerating and EM-DM growth differential is increasing External rebalancing has come a long way Inflationary pressures remain contained Real policy rates are still attractive Rate cuts across several EM economies 	<ul style="list-style-type: none"> Stronger USD; higher core rates Protectionist trade in the US Capital flight out of EM Hard landing in China, RMB devaluation Idiosyncratic risks in number of EMs External environment less supportive of risky assets
Emerging Markets Sovereign Credit (USD denominated) 	<ul style="list-style-type: none"> Synchronised global growth is supportive of the asset class. High uncertainty regarding Trump administration trade policies – potential to reverse the recent improvement in fundamentals. External rebalancing has come a long way Widening growth differential with DM is a positive. 	<ul style="list-style-type: none"> High dependence on global trade and commodity prices make the asset class vulnerable to shock. China tightening leads to chaotic deleveraging. Sustained oil rally a risk to the upside Stronger USD a key risk to the asset class
Investment Grade Credit 	<ul style="list-style-type: none"> M&A has accelerated with aggressive transactions leading to some IG ratings review Corporate credit fundamentals are broadly positive although leverage remains at elevated levels A peaking corporate credit cycle with spreads at recent tights, leverage high, and interest coverage low, we expect spreads to be range bound or widen 	<ul style="list-style-type: none"> Global CB's tighten more rapidly leading to rapid widening in an asset class with increasing spread duration Tax bill gives greater windfall than expected and companies use the extra cash for balance sheet maintenance
High Yield Credit 	<ul style="list-style-type: none"> Spreads are tight and leverage rising. Central banks beginning to normalize extraordinarily easy monetary policies. Although HY looks less rich than IG, especially on a spread duration basis, we expect spreads to be range bound or widen from here. 	<ul style="list-style-type: none"> Technical environment remains exceptionally supportive The grind tighter in spreads can continue for longer than fundamentals and valuation would warrant
Agency MBS 	<ul style="list-style-type: none"> Fed balance sheet normalization has had limited impact on spreads Although recent performance has made spreads relatively more attractive, a deluge of supply in conjunction with an absent fed buyer will likely push spreads wider 	<ul style="list-style-type: none"> Fed balance sheet normalization is not enough to dampen demand and spreads tighten and/or is slowed by Fed B.S. hits spreads and delinquencies/prepays accelerate
Non-Agency MBS & CMBS 	<ul style="list-style-type: none"> The Non-Agency market continues to be supported by improving fundamentals (home price gains, low delinquencies) and declining supply, while valuations remain reasonable. Non-Agency scarcity value as supply remains low. CMBS looks closer to fairly valued after the recent widening, and deterioration in deal structure and collateral has been relatively modest 	<ul style="list-style-type: none"> Tightening in credit conditions for US consumer Higher interest rates inhibiting home price appreciation Stress in traditional mall-based retail becomes more entrenched across the board
Commodities 	<ul style="list-style-type: none"> o/w Base. Copper + Nickel + Zinc o/w Corn + Beans vs Wheat o/w Silver vs Gold u/w US Natural Gas 	<ul style="list-style-type: none"> China tightening Slowing global growth

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