

In Credit

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Bond market blues, returns in the red

Markets at a glance

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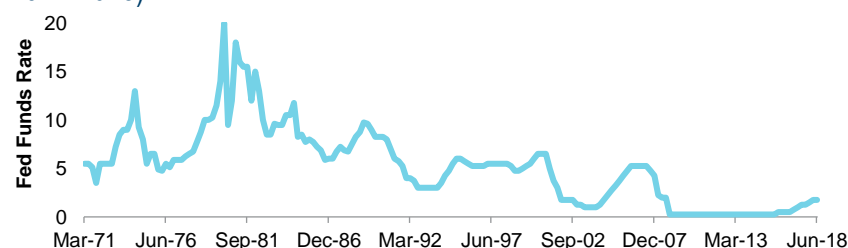
Kris Moreton

Investment Grade Credit

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	2.96%	6 bps	-0.6%	-1.7%
German Bund 10 year	0.48%	9 bps	-0.8%	0.7%
UK Gilt 10 year	1.42%	14 bps	-2.0%	-1.1%
Japan 10 year	0.05%	0 bps	-0.1%	0.5%
Global Investment Grade	121 bps	1 bps	-0.5%	-2.3%
Euro Investment Grade	116 bps	1 bps	-0.3%	-0.9%
US Investment Grade	122 bps	1 bps	-0.7%	-3.2%
UK Investment Grade	118 bps	-3 bps	-0.9%	-1.8%
Asia Investment Grade	191 bps	0 bps	-0.1%	-1.4%
Euro High Yield	374 bps	-2 bps	0.2%	-0.6%
US High Yield	345 bps	-10 bps	0.5%	0.2%
Asia High Yield	510 bps	1 bps	-0.1%	-3.1%
EM Sovereign	368 bps	2 bps	-0.6%	-4.8%
EM Local	6.5%	12 bps	-0.9%	-4.6%
EM Corporate	309 bps	-1 bps	-0.2%	-2.7%
Bloomberg Barclays US Munis	2.7%	0 bps	-0.1%	-0.4%
Taxable Munis	4.1%	5 bps	-0.8%	-2.8%
Bloomberg Barclays US MBS	31 bps	4 bps	-0.6%	-1.6%
Bloomberg Commodity Index	90.01	-0.5%	-0.8%	2.1%
EUR	1.1808	0.9%	0.9%	-2.1%
JPY	110.04	0.0%	-0.7%	2.8%
GBP	1.3424	0.5%	0.9%	-0.8%

Source: Bloomberg, Merrill Lynch, as at 11 June 2018.

Chart of the week: The path to normalisation? (Federal Funds rate, 1971-2018)



Source: Bloomberg, Columbia Threadneedle Investments, June 2018.

Key markets overview

Macro / government bonds

It has been a tough year so far for most areas of fixed income. A cursory glance at the cover sheet shows that US and UK government markets are in the red as are investment grade and European high yield areas of the market. Emerging markets have been especially weak, and it has only really been commodities that have bucked the negative trend – albeit modestly. This comes amid a period heightened political tension (G7, N Korea, Italy etc) and the ongoing normalisation of monetary policy in the US.

Core bond yields moved higher still over the course of the last week. European and UK markets were especially weak. Moving in the opposite direction were the bonds of Italy, where sovereign spreads were materially tighter over the week (10-year at around 30bps) after a more conciliatory / pro-European tone from a senior member of the new government.

Ahead of us this week lie a series of central bank meetings in Europe, Japan and the US. It will be interesting to see whether the European Central Bank mentions any plans to taper asset purchases later this year. In the US the Federal Reserve is expected to raise interest rates by 25bps in what will be the seventh rate rise in this present cycle (see chart of the week). There is also the historic summit between Kim Jung Un of North Korea and President Donald Trump of the US on Tuesday in Singapore. Perhaps he will get on better with this old adversary than he seems to be doing with his old allies at the G7? In specific data, Eurozone GDP expanded by 0.4% q/q in Q1, slowing appreciably from the 0.7% q/q pace of the last quarter of 2017. Year over year the growth rate is 2.5%. In the US, the service sector ISM rebounded to 58.6 beating consensus and last month's 56.8 reading.

Investment grade credit

Investment grade corporate spreads were largely unchanged in a 'news light' week. Peripheral European issuer's spreads, however, followed the direction of sovereign bonds and tightened. US investment grade corporate bonds posted a negative total return of 25bps last week, underperforming duration-matched US treasuries by 4bps. High quality and longer-duration bonds lagged, impacting the utility sector most significantly. Worth noting is the turn in foreign investor appetite; at 29% of the investor base, foreign investors, for the first time since Q2 2012, were net sellers of the asset class selling their US corporate bonds for US treasuries during Q1, 2018.

This week the European market will be looking for signs of any change in policy stance from the European Central Bank. Ultra-loose monetary policy has been a powerful and positive support for the market. This comes against a background of asset class outflows and a relatively quiet new issue market.

High yield credit

Despite the backdrop of volatility across global markets, US high yield spreads tightened over the last week amidst higher rates and equities and European spreads were fairly unmoved.

US high yield is one of the few fixed income markets in positive territory for total returns year-to-date. In terms of flows, high yield outflows spiked to -\$1.4bn over the week, according to Lipper. Thematically, the sell-off in rates has added pressure to 'BBs' performance and we continued to see 'CCCs' outperform. New issue activity continues to track well below seasonal norms, with only \$2.9bn priced month-to-date. As mentioned, in Europe, spreads were little moved over the week. As in the US, there are outflows from the asset class. In specific news Casino, the supermarket company, saw its bonds fall further after a negative equity market report.

Emerging markets

Emerging market hard currency spreads were broadly unchanged over the week after a period of some weakness.

The Brazilian currency was particularly strong at the end of the week as the central bank committed to support the exchange rate. In a policy news heavy week, Turkey surprised with another hike in rates to 17.25%. Argentina saw the roll-out of a larger than expected IMF programme (\$50bn) and India pushed policy rates higher by 25bps. The market saw an outflow of around \$1bn.

Asian fixed income

Asian credit weakened slightly last week, after an eventful week in broader emerging markets caused a bit of a spill-over effect in Asia.

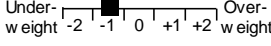
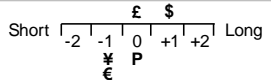
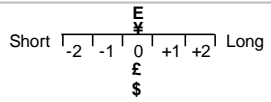
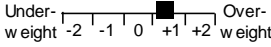
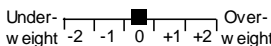
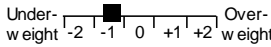
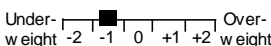
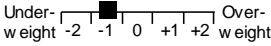
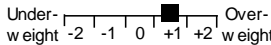
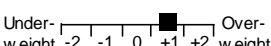
China saw some government intervention within several high-tech sectors. In the solar-related renewable energy space, the government announced that it would be suspending the construction of new solar farms and planning to cut subsidies. State-owned power generation company Shanghai Electric was reported to purchase 51% of the polysilicon unit of solar equipment manufacturer GCL Poly Energy. Meanwhile, optical film producer Kangde Xin signed a strategic cooperation with government-backed China Communications Construction Company. Within frontier markets, Sri Lanka saw the IMF approve the disbursement of another \$252m tranche. In the primary market there was \$3.6bn printed, with Singapore's DBS Bank coming to the market with its first ever Tier-2 bond. High yield only saw one issuance from Chinese Property developer Guangzhou R&F.

Commodities

The market was down 0.5% last week but has rallied by over 2% year-to-date.

Last week, it was base metal prices in general and copper prices in particular that supported the market. Copper prices rose by around 6% driven by strikes / wage negotiations at the Escondida mine in Northern Chile. Oil prices were a shade lower after poor inventory data in the US, precious metals held steady and grains fell for weather-related reasons.

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 tight. 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 tight
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 deflation 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 inflationary 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 reviews Corporate credit fundamentals are broadly positive although leverage remains at elevated levels A peaking corporate credit cycle with spreads at recent tight, 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 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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