

In Credit

18 JUNE 2018

Dovish ECB stabilises sentiment

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	2.92%	-3 bps	-0.5%	-1.6%
German Bund 10 year	0.40%	-5 bps	-0.7%	0.8%
UK Gilt 10 year	1.32%	-7 bps	-0.9%	0.0%
Japan 10 year	0.04%	-1 bps	0.0%	0.6%
Global Investment Grade	120 bps	-1 bps	-0.3%	-2.1%
Euro Investment Grade	111 bps	-5 bps	0.1%	-0.4%
US Investment Grade	121 bps	-1 bps	-0.5%	-3.1%
UK Investment Grade	116 bps	-2 bps	-0.1%	-1.0%
Asia Investment Grade	190 bps	0 bps	-0.2%	-1.4%
Euro High Yield	364 bps	-10 bps	0.6%	-0.2%
US High Yield	333 bps	-12 bps	0.9%	0.7%
Asia High Yield	507 bps	-3 bps	0.0%	-2.9%
EM Sovereign	379 bps	11 bps	-1.1%	-5.4%
EM Local	6.7%	12 bps	-2.8%	-6.4%
EM Corporate	313 bps	4 bps	-0.3%	-2.8%
Bloomberg Barclays US Munis	2.7%	2 bps	-0.2%	-0.5%
Taxable Munis	4.1%	-1 bps	-0.6%	-2.5%
Bloomberg Barclays US MBS	29 bps	-2 bps	-0.4%	-1.4%
Bloomberg Commodity Index	87.50	-2.5%	-3.3%	-0.5%
EUR	1.1569	-1.4%	-0.6%	-3.3%
JPY	110.59	-1.0%	-1.7%	1.9%
GBP	1.3240	-0.9%	-0.1%	-1.7%


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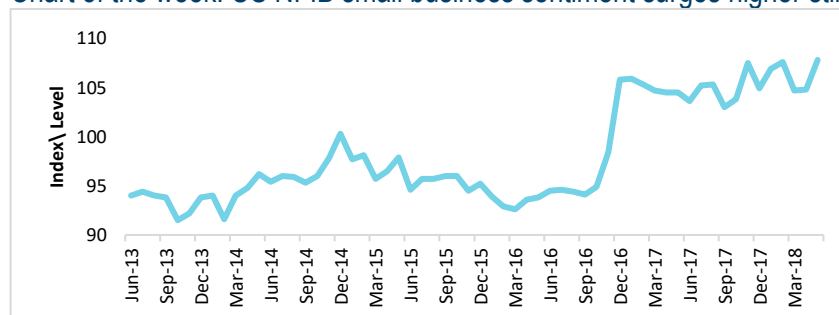
Mortgage / Asset Backed

Kris Moreton

Investment Grade Credit

Source: Bloomberg, Merrill Lynch, as at 18 June 2018.

Chart of the week: US NFIB small business sentiment surges higher still



Source: Bloomberg, Columbia Threadneedle Investments, June 2018.

Key markets overview

Macro / government bonds

Core government bond yields were a shade lower over the week led by Europe and the UK.

It was a week for policy announcements. In the US, the Federal Reserve increased rates for a seventh time in this cycle and signalled it has more to do. Specifically, it plans to raise rates a further couple of times this year, three times next year with one further hike in 2020. This was a not a change in the terminal interest rate, more a modest front loading of policy change. As expected the European Central Bank announced that QE will come to an end this year. In further forward guidance, the ECB mentioned that interest rates will not be changed in the first half of 2019. It was also a week of photoshoots and sound bites in Singapore as the leader of the free world met with the leader of North Korea. This summit yielded the signing of an agreement to promote further progress towards the denuclearization of the Korean peninsula.

The key monthly US inflation statistic came out in line with expectations. Core consumer prices rose by 0.2% to 2.2% y/y, its highest rate in around a year and a half. Small business sentiment rose to the highest level since 1983 (see chart of the week). A net 34% of firms surveyed believe it is a good time to expand.

In the UK, the employment report showed that the economy had added 146,000 jobs, taking the employment rate to a record high of 75.6%. Wages failed to keep pace and slowed to 2.8% y/y. Households are, however, enjoying the strongest period of real wage growth in more than a year. Inflation in the UK is cooling; the headline rate came in at 2.4% y/y, with a core rate of 2.1% y/y. There was also a weather / Royal wedding led bounce in retail sales. The pressure for the Bank of England to raise rates this week is fairly marginal.

Investment grade credit

Investment grade spreads were a little tighter last week led by European markets, where a dovish policy announcement by the ECB provided reassurance for the market.

In specific news, AT&T has been cleared to acquire Time Warner in a \$85bn acquisition. The media/telecom sector is rife with a heightened speculation about M&A activity. In other such activity, Cheong Kong announced a bid for APA Group the Australian gas pipeline operator. The new issue market picked up in terms of activity in the last five days.

US investment grade corporate bonds generated a positive total return of 26bps last week. Spreads were effectively unchanged, with the index OAS down from +122bps to +121bps. The long end significantly outperformed the short and intermediate parts of the curve given further yield curve flattening. Supply came as expected last week, with approximately \$25bn coming to market. It was mostly a week of one-off names, which will typically be less disruptive than mega-deals. This week is likely to have some mega-deals, with Walmart (\$10bn) and Bayer (\$15bn+).

High yield credit

High yield spreads were also tighter over the week.

US high yield bond prices rallied over the past week as investors focused on a number of different macro events. The FOMC meeting leaned a little hawkish, the ECB dovish, the US growth outlook received a large upgrade, and trade tensions with China are escalating. The asset class reported inflows totalling +\$324m over the week, according to Lipper. In Europe the market is also performing well with 'BB' rated credits leading the way. The new issue market has picked up with amongst others the recent Leveraged Buyout TDC and gaming company Cirsa expected to bring issuance.

Emerging markets

Emerging market bonds remain under pressure and, unlike credit markets, spreads were actually wider over the last five days. In all, hard currency spreads have widened from around 290bps over similar maturity US government bonds to nearly 380bps since the end of January.

In spite of the receipt of a large-scale IMF package, the Argentinian peso remains under pressure and fell by approximately 7% last week. There is a generally hawkish tone running through central bank activity with Russia leaving policy rates unchanged last week and both Brazil and Mexico central banks meeting this week with unchanged or modestly rising rates the expectation. The market remains in outflow (around \$1bn last week) and bereft of primary issuance.

Asian fixed income

Asian credit was slightly mixed last week.

China signalled its intentions to merge the pipeline assets of its three oil majors, CNPC, Sinopec, and CNOOC, into a single entity, likely to be named 'China Pipelines Corporation.' The value of the company is estimated to be up to RMB300-500bn and is the first step of the National Development & Reform Commission's pipeline reform plan. In Hong Kong, Swire Properties was reported to have sold its Hong Kong Towers assets for HK\$15bn. In India, Tata Steel Europe's merger with ThyssenKrupp is facing a few headwinds and the ThyssenKrupp management is looking to re-negotiate a better deal. The primary market was relatively quiet, with China's ICBC coming with a green bond, while Chinese property supply continued, this week with Future Land and Greenland.

Commodities

There was a sharp sell-off in commodities last week. The rise in the US dollar was in part to blame as was the expectation of an announcement of an increase in OPEC oil production at its meeting this week.

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"> Flattening bias in EUR and USD markets: decent near-term macro against low -trend growth European inflation and monetary policy normalisation not yet reflected in yields Australian macro outlook is for slow-burn deterioration 	<ul style="list-style-type: none"> Higher perception of US productivity/neutral rate European political/breakup risk Eurozone recovery fizzles out
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 twin 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 o/w Silver vs Gold u/w US Natural Gas 	<ul style="list-style-type: none"> Trade tariff escalation US v China, Canada, Mexico

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