

In Credit

25 JUNE 2018

Tough trade talk, no change in UK rates

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	2.87%	-5 bps	-0.4%	-1.5%
German Bund 10 year	0.32%	-8 bps	-0.3%	1.2%
UK Gilt 10 year	1.29%	-4 bps	-1.0%	-0.1%
Japan 10 year	0.04%	0 bps	0.1%	0.6%
Global Investment Grade	124 bps	4 bps	-0.4%	-2.2%
Euro Investment Grade	114 bps	3 bps	0.3%	-0.3%
US Investment Grade	127 bps	6 bps	-0.9%	-3.4%
UK Investment Grade	118 bps	2 bps	-0.3%	-1.1%
Asia Investment Grade	194 bps	3 bps	-0.2%	-1.4%
Euro High Yield	375 bps	11 bps	0.3%	-0.4%
US High Yield	339 bps	6 bps	0.9%	0.6%
Asia High Yield	518 bps	11 bps	-0.3%	-3.2%
EM Sovereign	376 bps	-3 bps	-0.7%	-4.9%
EM Local	6.6%	-1 bps	-2.4%	-6.0%
EM Corporate	319 bps	6 bps	-0.4%	-2.8%
Bloomberg Barclays US Munis	2.7%	-2 bps	0.0%	-0.4%
Taxable Munis	4.1%	0 bps	-0.5%	-2.5%
Bloomberg Barclays US MBS	30 bps	1 bps	-0.3%	-1.3%
Bloomberg Commodity Index	86.77	-0.4%	-3.7%	-1.0%
EUR	1.1651	0.4%	-0.2%	-3.1%
JPY	109.45	0.6%	-1.1%	2.4%
GBP	1.3236	-0.2%	-0.3%	-2.0%

Source: Bloomberg, Merrill Lynch, as at 25 June 2018.

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Emerging Market Credit

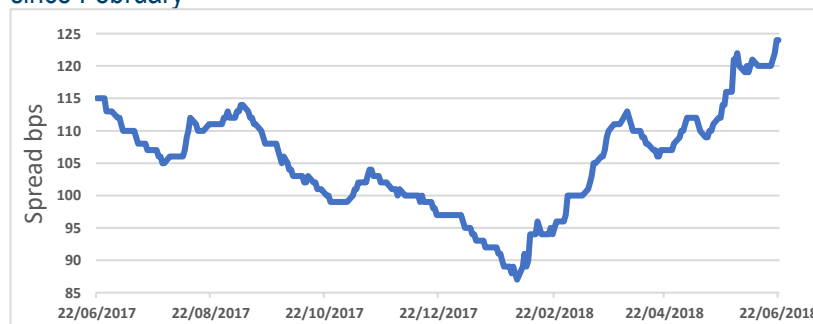
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Investment Grade Credit

Chart of the week: Global investment grade spreads – over 40% wider since February



Source: Bloomberg, Columbia Threadneedle Investments, as at 24 June 2018.

Key markets overview

Macro/government bonds

Core government bond yields were modestly lower over the course of the week, whereas credit spreads were wider in both investment grade and high yield.

The market's attention was on the unravelling trade tensions between the US and everyone else. Most importantly, the relationship with China brings worry about the effect on global growth.

The MPC met in the UK last week. The committee voted 6-3 to keep interest rates at the current 0.5%. The three dissenters voted to raise rates. The group also announced an expectation that the stock of QE purchases would remain unchanged until interest rates reach around 1.5%. All in, this is a slightly more hawkish outcome than had been expected, and takes the market-implied probability of a rise in interest rates at the August meeting to around 70%. Turning from monetary policy to fiscal issues, the UK public finance date for May displayed rapid progress and suggests fiscal consolidation can be reduced later in the year. At the end of the week, PMI data from the Eurozone came in no worse than expected, which in itself is different to most of this data this year.

Investment grade credit

Credit spreads remain under pressure and continue to widen, with global spreads now some 30% wider year-to-date (see chart of the week).

US investment grade bonds generated -45 bps of total return last week, underperforming all other US fixed income sectors including duration-matched government bonds. While corporate credit fundamentals are broadly positive, leverage remains at elevated levels and M&A has accelerated with some aggressive transactions leading to IG ratings reviews. Last week specifically, the Bayer and Walmart deals pressured the market. In our view, the recent backup certainly warrants revisiting some of the more beaten down sectors within the IG corporate bond space. We are also seeing a return of the foreign investor due to more favourable hedge yields, which could provide technical support in the back half of the year. Meanwhile, the European market is suffering from ongoing political tremors out of the periphery. So it is the UK market that is outperforming its US and European cousins.

High yield credit

US high yield bond prices were down in four of the five sessions this week.

Headlines for the week continued to be focused largely on the global trade outlook, and Thursday's profit warning by Daimler AG added to investor concerns. Other headwinds for markets were a weak Philadelphia Fed in June, the Supreme Court ruling that allowed states to start collecting sales tax from online retailers, and volatility in crude prices leading up to Friday's OPEC meeting to discuss easing production limits. The asset class reported outflows totalling -\$232 million, according to Lipper. Outflows for US high yield year-to-date total -\$22.6 billion.

European high yield spreads also drifted wider over the week with the new issue market generating most activity. Three transaction-motivated deals from TDC, Energizer and Cirsa were in particular focus. For the first time in several years the market witnessed a material push-back from investors on aggressive deal terms and pricing. The Italian/Spanish/LatAm gaming business Cirsa was subject to the most significant of these challenges, and eventually priced at 6.75% after initial talk around 5.5%; the bond documents were also materially tightened.

Emerging markets

After a rocky few weeks, the past five days have been a period of some consolidation for emerging markets, with hard currency spreads actually a few basis points tighter over the week.

Over the weekend President Erdogan was re-elected in Turkey. In other news the Brazilian central bank kept rates unchanged, whereas the Mexican Central Bank nudged rates higher by 0.25%.

Asian fixed income

Trade tensions between the US and China escalated last week, with tariffs being implemented and more threats being made. Asian credit spreads were generally wider, but this was offset by the rally in US Treasuries. The total return of the region was -0.1% last week. Within Asia, investment grade credit was unchanged, while high yield underperformed.

In China, the government was reported to propose a law to hold ecommerce platforms such as Alibaba and JD.com liable for fraudulent goods held by vendors on their platforms, in a bid to clean-up the online retail industry. In related tech news, Google invested \$550 million in JD.com to develop retail solutions not only Asia but also in the US.

The primary market saw only \$2.2 billion printed last week as demand remains weak. Notable deals included a FRN from China's ICBC International and a five-year bond from Korea's GS Caltex.

Commodities

The market recorded a decline of 0.4% last week. Commodity prices are being driven by two factors: first, a planned increase in production from OPEC of a million barrels a day came and went without incident, and oil prices actually moved higher over the week; and second, base metals prices were under some pressure given the backdrop of trade friction between the US and China/Europe described earlier.

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. 	<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"> 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-bum 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 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"> Fundamental performance across EM more idiosyncratic. 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. Have become more cautious on the dollar as short term rate differentials begin to work their way into currency markets. 	<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 Isolationist trade policies from new US administration present further risks to the downside.
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 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 weight to 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. 	<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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