

In Credit

14 MAY 2019

Trade tariff troubles ...

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	2.42%	-10 bps	0.4%	2.3%
German Bund 10 year	-0.05%	-8 bps	0.4%	2.0%
UK Gilt 10 year	1.12%	-10 bps	0.4%	2.3%
Japan 10 year	-0.05%	-1 bps	0.1%	1.2%
Global Investment Grade	122 bps	5 bps	0.1%	4.7%
Euro Investment Grade	118 bps	9 bps	-0.1%	3.7%
US Investment Grade	122 bps	4 bps	0.0%	5.6%
UK Investment Grade	126 bps	5 bps	0.1%	4.0%
Asia Investment Grade	203 bps	6 bps	0.3%	4.4%
Euro High Yield	422 bps	28 bps	-0.8%	6.5%
US High Yield	401 bps	29 bps	-0.5%	8.3%
Asia High Yield	529 bps	20 bps	-0.2%	8.3%
EM Sovereign	373 bps	11 bps	0.0%	6.7%
EM Local	6.2%	0 bps	-0.2%	2.5%
EM Corporate	325 bps	8 bps	0.2%	6.2%
Bloomberg Barclays US Munis	2.2%	-8 bps	0.6%	3.9%
Taxable Munis	3.5%	-8 bps	0.9%	6.1%
Bloomberg Barclays US MBS	43 bps	6 bps	0.3%	2.4%
Bloomberg Commodity Index	78.63	-1.5%	-2.4%	2.5%
EUR	1.1230	0.3%	0.2%	-2.0%
JPY	109.66	1.0%	1.3%	-0.3%
GBP	1.3009	-1.3%	-0.3%	1.9%



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Source: Bloomberg, Merrill Lynch, as at 13 May 2019.

Chart of the week: US unemployment rate near 50-year low



Source: Macrobond Financial, 13 May 2019.

Macro/government bonds

It has been a busy couple of weeks in terms of economic data releases, though core government bond markets have not moved appreciably on this type of news. Rising trade tension rhetoric between the US and China, as well as the imposition of trade tariffs by the US, has been the stronger force in terms of market direction. This uncertainty has supported core government bond prices – though it was a more difficult period for risk assets such as credit and equities.

Turning to the data, in the US the ISM manufacturing activity index fell to 52.8 in April, signalling the slowest pace of growth in more than two-and-a-half years. Non-Farm Payrolls rose 263,000 in April, better than the highest estimates. The six-month average job growth remains above 200K, which is remarkable in the tenth year of the US economic expansion. The unemployment rate fell to a 50-year low of 3.6% (see Chart of the Week). Average hourly earnings rose a modest 0.2% month-on-month in April but kept the year-on-year pace slightly above 3%. Consumer confidence rose to 129.2 in April and is near its 12-month average level. Consumer price inflation also rose less than expected as lower clothing and used car prices kept core inflation contained.

In Europe, German Industrial Production increased by a 0.5%, which was a larger increase than expected

In the UK GDP fell by 0.1% month-to-month in March, though the quarterly data confirmed a 0.5% rise in the first quarter as a whole which is better than the preceding quarter. The manufacturing component drove 0.2% of the rise, however this should reverse in Q2 owing to less anticipated stockpiling compared to the original Brexit date.

Investment grade credit

Investment grade credit spreads were slightly wider across the major markets last week, with trade tariff headlines driving the moves. Results season continues apace with corporates generally reporting earnings that are in line with expectations. The relative weakness in the market last week was not enough to deter two mega deals, with one from US pharma company Bristol-Myers Squibb which issued \$19 billion to finance its acquisition of Celgene, and another from IBM which issued \$20 billion to finance its acquisition of Red Hat.

High yield credit

US high yield bond prices held in relatively well amid the past week's 3% decline in equities as investors absorbed the heaviest new-issue activity since late 2017, as well as numerous headlines and media reports ahead of this week's tariff hike. Despite equity weakness, new-issue activity over the past week totalled \$12 billion and was the heaviest since December 2017. The asset class reported a modest outflow of -\$212million, according to Lipper.

Since the start of May, European high yield has been considerably weaker, which has eaten away some of the high returns the asset class has had year-to-date. Just as the primary market during the first quarter was subdued, right now it is very animated. We have seen several new issues including a new deal from Dutch broadband operator Ziggo, Spanish gambling services provider Cirsa, and a revival of a November deal from British grocer The Co-operative, which had not priced due to market sell-off at the end of last year. Corporate news focused on the usual suspects, especially Jaguar Land

Rover, as rumours emerged that Peugeot was in talks with Tata about its potential acquisition of JLR, which Tata later denied. Additionally, the company published numbers showing a drop in sales, most notably in China. Last week, we saw positive flows into the asset class.

Leveraged loans

Returns on US bank loans are now slightly negative on the month as heightened trade war concerns have spooked risk assets generally. While still outperforming and outyielding high yield bonds, the sector is down 9 bps in May. Outflows have moderated, but it's worth noting that the asset class has endured 24 consecutive weeks of withdrawals totalling \$34 billion. Offsetting a lack of retail demand and helping to buoy loan prices is the CLO market. Net new CLO issuance totalling \$46.2 billion YTD is up 4% year-on-year. Anaemic gross and net new loan issuance has also helped maintain a strong average dollar price of \$97.8, however the use of proceeds has shifted from primarily refinancing and re-pricings to 36% LBOs and 28% M&A. Default activity picked up a bit in April, ending the month at 1.3%, however we continue to expect defaults to remain benign over the course of 2019.

Structured credit

Risk-off environments are generally positive for agency MBS, hence the sector's strong start to the month. In US markets the sector is outperforming all asset classes, save treasuries and municipals, on the month. Agency MBS supply continues to be a concern over the near term as prepays increase on lower interest rates and issuance rises in the bigger home buying months of spring. Non-agency MBS performance remains strong. Home price appreciation has decelerated to slightly above inflation, improving affordability, and is more in-line with longer-term trends. In the ABS sector consumer credit performance remains in-line with expectations as underwriting standards remain tight. Marketplace lending remains an attractive area given the short, de-levering structures. Retail CMBS remains a weak spot, however more broadly commercial real estate fundamentals are healthy.

Emerging markets

Emerging markets were slightly weaker on the week, although there was little in terms of reaction to the news of the 25% tariffs applied by the US on more than \$200 billion worth of Chinese imports. It is not currently clear how China intends to retaliate. Turkey was in the headlines once again with negative news flow including a potential election recount, the current account deficit which reached \$590 million, and falls in both the lira and FX reserves. More positively, Cyril Ramaphosa was re-elected president of South Africa. This is positive for the reorganisation of state-owned utility Eskom and will hopefully pave the way for more land reforms. The asset class saw inflows slow to \$422 million on the week, according to JP Morgan, but this was despite a \$466 million outflow from ETFs.

Asian fixed income

Asian credit suffered some mid-week jitters, ending on a weaker note due to the resurgence of US and China trade tensions. China extended its influence in Eastern Europe, with the country's leading nuclear power generation company, China General Nuclear Power, reaching a deal with a Romanian state firm to build a plant in the country. Within China properties, China's Evergrande raised China's largest onshore bond from

a dual-tranche offering of up to RMB20 billion at an average yield of 6.3%. China industrial gas producer Yingde Gases secured a \$300 million unsecured loan with 15 lenders, strengthening its liquidity profile by adding another source of funding. In Macau gaming, New Cotai, a shareholder of Macau's Studio City, filed for bankruptcy which prompted speculation that majority owner Melco Resorts & Entertainment may take the opportunity to acquire the asset.

Commodities

Central bank buying, as well as demand from equity investors, is providing some support for gold. Meanwhile, Crude oil has come off the highs after the market digested aggressive posturing towards Iranian exports. It now looks like it will be more difficult to shut off the taps than originally planned. Base metals have been weak due to escalation of the trade war and fears that it may not be over before Christmas. This area of the market had previously been pricing in a very near-term resolution. Zinc was particularly weak amid rising inventories and lower indications of demand.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

13th May 2019

Strategy and positioning (relative to risk free rate)	Views	Risks to our views
Overall Fixed Income Spread Risk 	<ul style="list-style-type: none"> The rapid deterioration in global growth looks to have stabilized, but signs of a sustained recovery have not become evident. Valuations have recovered and certainly seem to be reflecting an optimistic view on the growth recovery. It is late in the cycle, so it is prudent to be conservative. 	<ul style="list-style-type: none"> Faster than expected rebound in global growth, or further US fiscal stimulus. Inflation in the US accelerated and emboldens the Fed to resume hikes.
Duration (10-year) ('P' = Periphery) 	<ul style="list-style-type: none"> Lower estimates of terminal Fed rate provide support for Treasury yields as growth grinds towards trend in 2019 European macro backdrop still weakening; ECB accommodation supports semi-core and peripheral bonds 	<ul style="list-style-type: none"> Accelerating wage and price inflation may raise perception of neutral US rates Softer Fed stance and global trade détente stimulates improvement in risk sentiment
Currency ('E' = European Economic Area) 	<ul style="list-style-type: none"> The end of the Fed and catch down of US economic outperformance to the RoW, along with corporate repatriation, which may have offered USD support, has ended and twin deficits have deteriorated The paths to a benign Brexit outcome have increased although the path to these outcomes will be volatile. 	<ul style="list-style-type: none"> Re-steepening of US yield curve and repricing of the Fed Parliamentary majority against no-deal fails to avert the worse outcome
Emerging Markets Local (rates (R) and currency (C)) 	<ul style="list-style-type: none"> EM Local asset class has benefited from a dovish shift across DM central banks. Local rates have underperformed other risk assets ytd, suggesting decent risk premia remain Real interest rates relatively attractive Fundamentals still reasonable in most EMs 	<ul style="list-style-type: none"> Return of EM inflation fears via USD strength Re-tightening of DM central bank policy stance Contagion from idiosyncratic problems, such as Turkey and Argentina
Emerging Markets Sovereign Credit (USD denominated) 	<ul style="list-style-type: none"> Fundamental performance across EM more idiosyncratic. Have passed through most significant uncertainties (USMCA, Election cycle, etc.) but US-China trade remains potential headwind. Bounce back in idiosyncratic names has helped EM outperform US counterpart through recent widening EM spreads have disconnected from recent dollar strength which typically does not persist 	<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 US-China trade negotiations falter and full range of tariffs are implemented
Investment Grade Credit 	<ul style="list-style-type: none"> More management teams are now following through with deleveraging following several years of M&A. US and European growth stabilizing in the 1-2% range can be a sweet spot for IG, through accommodative central banks but avoidance of recession 	<ul style="list-style-type: none"> Recession in the US and/or Europe, especially led by weakening consumer demand puts in focus downgrade risks.
High Yield Credit 	<ul style="list-style-type: none"> Valuations are unattractive relative to other asset classes Forecasted default rates remain low relative to historical averages, which offsets deteriorating global growth trends Technicals remain positive with low issuance and positive flows 	<ul style="list-style-type: none"> Oil falls amidst global demand concerns and US stockpiling Default rate unexpectedly climbs due to weaker operating environment and tighter financial conditions
Agency MBS 	<ul style="list-style-type: none"> The convergence of agencies in the Universal MBS has deteriorated the quality of the pool of assets The Fed will continue to sell MBS even as it slows Quantitative Tightening Prepayments have increased significantly with lower rates 	<ul style="list-style-type: none"> Volatility remains extremely low to enable further good performance
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. Non-Agency spreads have lagged other IG spreads in the YTD rally 	<ul style="list-style-type: none"> Tightening in credit conditions for US consumer Higher interest rates significantly 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 Gasoline vs WTI o/w Cu, Ni, AL vs Gold and Zinc o/w Natural Gas u/w sugar vs o/w coffee 	<ul style="list-style-type: none"> Material China slow down, weighing on economic growth, metals & petrol

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