For Investment Professionals only

M&G INSTITUTIONAL

# Covid-19 FI Update briefing

A round-up from across the fixed income market

15 May 2020

M&G Institutional fixed income businesses

- Data releases for Q1 2020 and April have provided evidence of the extent of the slowdown many countries have experienced as a consequence of lockdowns undertaken to combat Covid-19. The US unemployment rate increased to 14.7% as more than 20 million jobs were lost in April.
- We have been active in credit markets during the crisis, applying some dry powder in selected investment grade issuers across a range of sectors when valuations were highly attractive. European high yield markets have recovered around half of March's losses, supported by central bank and government policies, despite pricing in unprecedented default rates.
- There have been the first tentative signs of new issuance in the European loans market, coming from Nielsen, included within a larger issue.



## Fixed income market indicators (as at 11 May 2020)

| | Current | | | |
|---|---|---|---|---|
| **Governments** | **Yield** | **Change (since 30-Apr)** | **Change (since 31-Mar)** | **Change (since 31-Dec)** |
| US Treasury – 10 year | 0.71% | +7 bps | +4 bps | -121 bps |
| German Bund – 10 year | -0.51% | +8 bps | -4 bps | -32 bps |
| UK Gilt – 10 year | 0.27% | +4 bps | -9 bps | -45 bps |
| **Corporate credit** | **Spread** | **Change (since 30-Apr)** | **Change (since 31-Mar)** | **Change (since 31-Dec)** |
| US Investment Grade (C0A0) | 223 bps | -12 bps | -77 bps | +118 bps |
| Euro Investment Grade (ER00) | 189 bps | +41 bps | -8 bps | +130 bps |
| Sterling Investment Grade (UN00) | 174 bps | +21 bps | -16 bps | +78 bps |
| iTraxx Crossover Index | 507 bps | +2 bps | -66 bps | +300 bps |
| US High Yield (H0A0) | 751 bps | -21 bps | -96 bps | +398 bps |
| Euro High Yield (HEAD) | 654 bps | +56 bps | -100 bps | +375 bps |
| **Leveraged loans** | **Discount margin** | **Return (week)** | **Return (MTD)** | **Return (YTD)** |
| European Loans index * (CS WELLI 4YDM) | 643 bps | 0.15% | 0.94% | -7.44% |

Sources: M&G. Bloomberg, ICE BoA indices, CS Western Europe Leveraged Loan Index 4yr discount margin (* Loans data as of 14 May 2020),

## Macro perspective

- Economic data continues to demonstrate the initial negative effects the economic shutdowns across the world are having. US GDP in the first quarter of 2020 declined by 4.8%, while the unemployment rate spiked to 14.7% in April, as more than 20 million jobs were lost. Just two months previously it had reached a 50-year low of 3.5%.
- Across Europe and in the UK, economic activity was confirmed to have been markedly weaker in March as Industrial Production declined by more than 20% month-on-month in some cases. April seems unlikely to offer more positive news as lockdown restrictions typically lasted across the whole of April.
- The decline in oil prices has helped to depress inflation rates. In the US, CPI was -0.8% month-on-month in April, the sharpest monthly fall in prices since December 2008, when the Global Financial Crisis was peaking. Within that however, the US and Europe have experienced a notable increase in food inflation.
- Economic data is by nature, lagging, and it may take several months for the true economic impact of the lockdown to become visible.

## Government bonds

- The US Treasury announced it would issue a new 20-year bond, the first such maturity since 1986, as part of $3 trillion of bonds issuance planned for the second quarter.
- Yields on US Treasuries have been confined to a range for much of the past three weeks, though declining on the extreme unemployment data. Elsewhere UK gilt and German bund yields have also continued their general softening trend.
- The Eurozone continued to suffer further political dislocations in the face of, primarily German and Dutch, opposition to any form of communal EU debt issuance. This particularly impacted Italian government debt yields which continued to widen relative to Germany.

## Investment grade credit

- In recent weeks we have used some of the dry powder to add credit risk in some strategies. We have favoured long-dated investment grade as we believe the spread duration available made these assets very attractive.
- We have not focused on a particular sector, but have added names in Healthcare, Technology, Basic industries and Capital goods. However, we stayed away from some of the sectors that are directly affected by the lockdown such as airlines, cruise ship operators and hotels. It is difficult to model the likely long term experience for companies in those sectors.
- High quality GBP and EUR corporate bonds are in some instances trading close to pre-Covid levels.

## High yield credit

- The high yield market's short spread duration meant that we believed better returns were initially available in the investment grade market. The very solid technical backdrop to the market in recent weeks has made us a seller of some of those issue that we bought in March.
- Markets are still pricing in unprecedented default rates.
- Some BB-rate credits are trading well inside BBB-rated bonds. This could imply that investment grade investors are becoming more risk averse to issuers that could potentially be downgraded.
- Despite April's partial recovery, HY markets are still pricing in a lot of bad news. At an option adjusted spread (OAS) of 422bps, euro BBs are pricing in almost 30% defaults over the next five years, assuming a 40% recovery rate. This compares to the worst ever historical five-year default rate of nearly 20%.

## Leveraged loans

- There were the first tentative signs of new European loan issuance – a EUR tranche was included within a USD 800m-equivalent issue by Nielsen, the highly-rated media company.
- The UK car auctions clearing concern, BCA, also recently issued a small, EUR 67m, add-on 3-year facility (at +550bps).

- J Crew was the latest US retailer to file for bankruptcy protection under Chapter 11, with over USD 1bn in loans outstanding.  US default rates - growing and higher than Europe - are still low, overall, at 2.5%, but, in the retail sector, they have spiked to over 7%.
- The incurrence of debt may create a new cadre of zombie companies from here and, while lockdowns are easing, allowing companies to restart operations, it is important to remember that the emergence effect will be multi-layered.