COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

26 JULY 2021

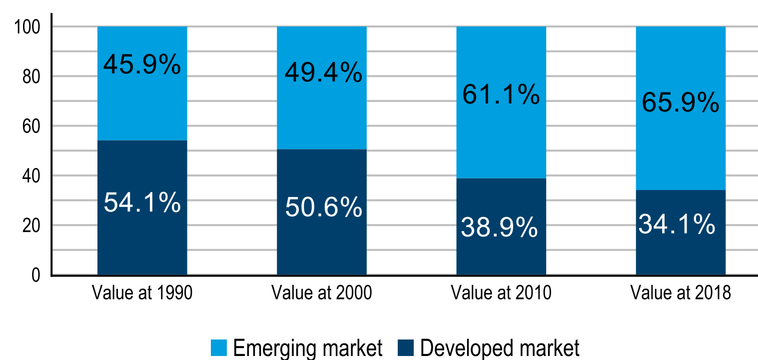
And now a summer lull

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.24%	-5 bps	1.1%	-1.6%
German Bund 10 year	-0.42%	-7 bps	1.6%	-1.2%
UK Gilt 10 year	0.57%	-5 bps	2.6%	-3.4%
Japan 10 year	0.01%	-1 bps	0.5%	0.3%
Global Investment Grade	93 bps	1 bps	0.8%	-0.1%
Euro Investment Grade	85 bps	2 bps	0.9%	0.5%
US Investment Grade	92 bps	1 bps	0.9%	-0.2%
UK Investment Grade	91 bps	0 bps	1.3%	-1.2%
Asia Investment Grade	212 bps	3 bps	0.7%	0.0%
Euro High Yield	318 bps	6 bps	0.2%	3.2%
US High Yield	322 bps	4 bps	0.3%	4.0%
Asia High Yield	630 bps	39 bps	-1.1%	-0.6%
EM Sovereign	325 bps	3 bps	0.5%	-0.5%
EM Local	4.9%	-2 bps	-1.1%	-4.5%
EM Corporate	311 bps	5 bps	0.4%	1.6%
Bloomberg Barclays US Munis	0.9%	-2 bps	0.8%	1.9%
Taxable Munis	2.1%	-1 bps	1.6%	2.1%
Bloomberg Barclays US MBS	31 bps	-3 bps	0.5%	-0.3%
Bloomberg Commodity Index	204.81	1.3%	1.2%	22.6%
EUR	1.1793	-0.3%	-0.7%	-3.6%
JPY	110.31	-0.4%	0.5%	-6.5%
GBP	1.3787	-0.1%	-0.6%	0.6%

Source: Bloomberg, Merrill Lynch, as at 23 July 2021.

Chart of the week: Global Greenhouse Gas Shift, DM to EM



Source: Macrobond and Columbia Threadneedle Investments, as at 26 July 2021.

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Macro / government bonds

Core government bond yields continue to be well supported. Yields are well below the highs seen at the end of the first quarter, pushed lower by falling real yields and reduced inflation expectations. Markets remain concerned that the Delta variant of the Covid virus could upset the re-opening trends seen in many economies. High levels of seemingly efficacious vaccines offer evidence that this wave is different to those preceding it, in terms of the link between infection and hospitalisation. President Biden offered his support to the notion that although inflation has risen, the lift in prices should be temporary.

There was little data to grab attention, though UK retail sales were stronger than expected while European consumer sentiment surprised in the other direction.

Investment grade credit

After a seemingly endless period of low volatility there was a brief push higher in spreads – coincident with the same themes outlined above. This was short lived however and not meaningful in size.

Corporate results are following the encouraging trend delivered by banks the prior week. Numbers out of bellwethers such as Verizon, Coca Cola and Johnson & Johnson were well received. As we enter the summer lull markets remain supported by ongoing supportive policy conditions, growth in the economy, improving credit trends and lower issuance than last year. Valuations however offer little room for material upside and trade through both short- and longer-term averages.

High yield credit

US high yield bond prices ended the week only slightly lower after exogenous risks led to a sharp risk-off move on Monday. However, spreads ended only 4bps wider over the week after widening 26bps on Monday. The ICE BofA US HY CP Constrained Index returned 0.09% over the week. Primary issuance paused briefly with Monday's volatility but returned to normal by mid-week. Outflows continued for the asset class with a $742m withdrawal from retail funds.

European high yield spreads finished wider after experiencing some market softness in the first half of the week, with travel and leisure sectors heaviest hit. Flows were negative due to redemptions from managed accounts as ETFS experienced a small inflow. Primary market pace eased to its lightest level in recent months with only three deals totalling less than €850m. In a sign of how much the market has changed, cruiseline company Carnival came out with a USD deal at 4% to refinance bonds they had issued last year at 11.5%.

The second quarter earnings season has started with already some encouraging results coming from cyclicals with signs of margins increasing and promising leverage trajectory.

Leveraged loans

Unlike high yield bonds, leveraged loans did not largely recover from Monday's price decline over the course of the week. The average price of the J.P. Morgan Leveraged Loan Index ended the week at average price of $98.45 – $0.13 lower, after declining $0.15 on Monday. After 27 straight weeks of inflows, US loan funds saw an outflow of roughly $67m for the week, according to Lipper. YTD net inflows total approximately $21.3bn.

Structured credit

The US Agency MBS market was up 18bps last week, performing in line with other high-quality asset classes. The risk-off market tone related to a possible resurgence of Covid-related viruses and its impact on the economy improved the relative safety-bid. In ABS, secondary spreads were stable despite heavy new issue volume as credit trends continue their positive trajectory. CMBS spreads were also relatively stable despite rising Delta-variant concerns and higher rate vol. Monthly Commercial Real Estate volume totaled $59.6bn in June – 197% higher than June 2020 and 8% higher than June 2019. Distressed sales have been muted as CRE property values increased nearly 10% on average. In the non-qualified (Non-QM) RMBS space, recent interest rate volatility has impacted prepay risk in differing ways across mortgage types. Investor mortgages have tended to prepay at a slower pace, while rising home equity values are acting as an accelerator, specifically in prime jumbo. Note that 86% of the outstanding Non-QM (non-qualified mortgage) universe has a mortgage rate above 5% vs just 4% of the Prime universe. The level of documentation has also proven to be a factor with full doc loans prepaying more quickly vs other types of alternative documentation.

Asian credit

S&P lowered its rating outlook for Adani Electricity Mumbai (AEML) to negative to reflect the potential deterioration of the consolidated Adani Transmission Ltd (ATL) group's credit quality. The stand-alone "BBB-" rating of AEML remains unchanged. S&P believes that timely tariff adjustments and a recovery in power sales volume will support AEML's financial profile over the next three years.

The State Administration for Market Regulation (SAMR) imposed a penalty of CNY500K on Tencent Music Entertainment (TME) and ordered the company to give up its exclusive music streaming rights on music labels. In 2018, TME's sub licensing fees came under SAMR's scrutiny because TME held the exclusive rights from Universal Music Group (UMG), Warner Music and Sony Music Entertainment to stream Western music to China. Following the SAMR's investigation in 2018, TME did not renew some of its exclusive rights which generally expired after three years.

The debt issues and funding challenges of the China Evergrande Group (Evergrande) continue to be in the spotlight. Earlier in the week, several banks in Hong Kong were reportedly considering the suspension of mortgages to Evergrande's two projects that are under construction in Hong Kong. However, following an enquiry by the Hong Kong Monetary Authority (HKMA) on Friday, HSBC Holdings PLC and Bank of China are reportedly reconsidering their mortgage suspension. The market is watching whether regulators in China and Hong Kong are taking any measures to prevent the systemic risk from Evergrande's financial distress.

Emerging Markets

In China, vice foreign minister Xie Feng declared the US/China relationship as in "stalemate", following US/China talks, stating that some Americans seek to portray China as an "imagined enemy".

In central bank news, Russia hiked its benchmark rate by 100bps to 6.5%. This takes total 2021 hikes to 225bps. Inflation stands at 6.5% in June, far exceeding the 4% central bank target.

In Peru, socialist candidate Pedro Castillo was elected as president after beating right wing candidate Keiko Fujimori by a slim margin. Castillo has pledged to nationalise Peru's mining and hydrocarbon sectors.

Commodities

Coffee prices surged 17.1% last week following frost in Brazil's coffee belt, taking coffee prices to seven-year highs. Brazil is also recovering from the worst drought in a century, which had already weakened coffee trees. Analysts have downgraded next year's crop by 5-10%.

Natural gas prices rallied 10.5% due to the ongoing heatwave driving air-conditioning demand. Drilling remains subdued, and supplies are lower than usual for this time of year, which is causing concern for the peak demand winter season.

Responsible investments

Our **Chart of the Week** shows how, since 1990, greenhouse gas (GHG) emissions have consistently moved from a top-heavy developed market contribution to almost two thirds coming from emerging markets by 2018. With the upcoming COP26 meeting in Glasgow this November, it's clear more needs to be done by all nations to meet important climate targets.

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	Under-weight -2 -1 0 +1 +2 Over-weight	■ The worsening Delta variant is threatening global reopening/growth stories as case counts rise and restrictions return. In areas with high vaccination rates, low mortality rates may deter policy moves. ■ Credit fundamentals across sectors are improving. In fact, some areas see such strong demand turnaround that supply constraints are throttling further growth. ■ Spreads are near all-time tights and leave little room for the growth story to get derailed, but pockets of opportunity with deleveraging & upgrade activity exist. ■ We are past the peak of central bank accommodation. The pullback in liquidity won't be aggressive, but it leaves opportunity for market volatility.	■ Upside risks: the unique COVID recovery in fundamentals allow spreads to rocket past all-time tights. Spreads have spent extended periods near tights in other periods as well. ■ Downside risks: Once spreads hit these extreme levels, future returns are rarely good. Both fiscal and monetary stimulus are removed just as growth decelerates could cause a sell off.
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long £ €	■ Rangebound government bond market likely, with bias to lower yields ■ Pandemic scarring keeps reflation credibility low ■ Fed QE and high personal savings underpin demand for treasuries ■ ECB likely to lean against rising financing rates ■ Duration remains best hedge for further risk asset correction	■ Permanent fiscal policy shift rebuilds reflationary credibility and raises r* ■ Fiscal largesse steepens curves on issuance expectations ■ Consumption rebound stimulates long-term inflation expectations ■ Risk hedge properties deteriorate
Currency ('E' = European Economic Area)	¥ £ EM Short -2 -1 0 +1 +2 Long E A$ $	■ US growth outperformance on back of fiscal stimulus boosts USD ■ ECB increasingly sensitive to Euro appreciation	■ Vaccine rollout in Europe improves and narrows growth gap ■ US fiscal push fades
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ Selective opportunities ■ Still-favourable global liquidity conditions ■ Dollar resilience may crimp scope for EMFX performance ■ EM real interest rates relatively attractive, curves steep in places	■ Central banks tighten aggressively to counter fx weakness ■ EM inflation resurgence ■ EM funding crises drive curves higher and steeper
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	■ Dispersion in outlooks across EM is rising as the recovery begins at different paces. Countries with commodity exposure and better fiscal adaptability rise to the top. ■ Index composition changes over the last 5 years have added a lot of duration to the sector, leaving especially IG EM vulnerable. We prefer HY EM (selectively). ■ US growth outperformance is starting to cause weakness in EMFX, and financial conditions for EMs is tightening.	■ A replay of 2013 occurs with a taper tantrum or swift appreciation of the USD ■ Growth scars from COVID persist and hurt commodity prices & ability to grow out of deficits. ■ There are even further delays in mass vaccination outside of developed markets.
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	■ US spreads are the tightest since 2005, when average credit quality was higher and duration was 50% lower. ■ Balance sheets weathered 2020 well, and are deleveraging due to responsibly capital management and good sales growth. ■ IG has been historically resilient in the face of inflation, even if other sectors may benefit more from it.	■ IG bonds further cement their place in global investors' portfolios as safe assets, replacing government bonds. ■ M&A and shareholder returns remain in the backseat of management's priorities for an extended period of time.
High Yield Credit	Under-weight -2 -1 0 +1 +2 Over-weight	■ Spreads are nearly to all-time tights, although credit quality has improved through defaults and ample liquidity ■ The best performing parts of these sectors have been the most volatile and lowest quality. ■ Defaults are set to drop dramatically in 2021 in part due to the rapid recovery, but also due to an ability to remove near-term maturities by companies across the credit spectrum.	■ The reach for yield continues to suppress spreads. ■ Waves of ratings upgrade begin to occur this year. ■ There are few exogenous shocks that shake the tight spread environment.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ Although spreads have recently widened a touch, the Fed buying has overwhelmed highly negative fundamentals, evidenced by the near-zero spreads in bonds the Fed buys and poor performance elsewhere. ■ These unattractive technicals may persist if the Fed continues buying. Fed buying cannot be expected to increase in 2021, ultimately exposing negative fundamentals and valuations. ■ Duration in the sector is now rising quickly as mortgage rates move higher.	■ Housing activity slows considerably and prepays move back down to normal levels, without denting households' ability to service mortgages. ■ The Fed maintains or increases MBS purchases next year.
Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ Our preference remains for non-agency RMBS in this area. ■ RMBS: Housing continues to outperform in the recovery as HH balance sheets are strong, demographics are positive, and supply is constrained. Valuations are less compelling, but can provide stable carry in de-risking portfolios. ■ CMBS: favoured bonds are still 'story' bonds. A return to normal won't look 'normal' for sectors like office space or convention hotels ■ Spread tightening looks somewhat excessive along the margins of credit quality.	■ Changes in consumer behaviour in travel and retail last post-pandemic. ■ Work From Home continues full-steam-ahead post-pandemic (positive for RMBS, negative for CMBS). ■ Rising interest rates may dent housing market strength, but seems unlikely to derail it.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	■ o/w Copper & Lead vs Zinc ■ o/w Grains ■ u/w Livestock ■ u/w Gold ■ u/w Natural Gas	■ US China trade war ■ Renewed Covid lockdowns

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