COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

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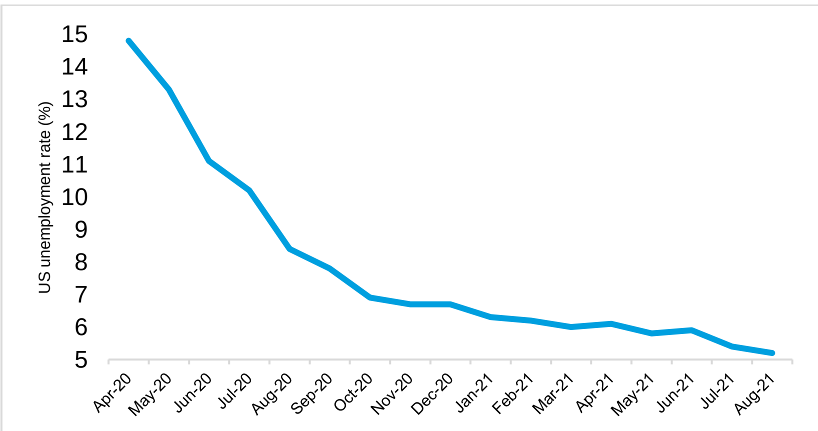
Falling into Fall.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.32%	2 bps	-0.1%	-1.6%
German Bund 10 year	-0.35%	7 bps	-0.2%	-1.7%
UK Gilt 10 year	0.72%	15 bps	0.1%	-3.9%
Japan 10 year	0.05%	2 bps	-0.1%	0.2%
Global Investment Grade	92 bps	-1 bps	0.0%	0.0%
Euro Investment Grade	85 bps	-1 bps	-0.1%	0.2%
US Investment Grade	92 bps	0 bps	0.0%	-0.1%
UK Investment Grade	89 bps	-1 bps	0.1%	-1.2%
Asia Investment Grade	200 bps	1 bps	0.0%	0.9%
Euro High Yield	310 bps	-3 bps	0.1%	3.9%
US High Yield	314 bps	-3 bps	0.2%	4.8%
Asia High Yield	682 bps	19 bps	-1.3%	-3.0%
EM Sovereign	310 bps	-7 bps	0.1%	0.6%
EM Local	5.0%	4 bps	0.1%	-3.0%
EM Corporate	303 bps	-4 bps	0.1%	2.3%
Bloomberg Barclays US Munis	1.0%	1 bps	0.0%	1.5%
Taxable Munis	2.1%	2 bps	-0.1%	2.2%
Bloomberg Barclays US MBS	33 bps	-1 bps	0.0%	-0.3%
Bloomberg Commodity Index	207.38	0.8%	1.2%	24.5%
EUR	1.1859	0.7%	0.6%	-2.8%
JPY	109.92	0.1%	0.3%	-5.8%
GBP	1.3833	0.8%	0.8%	1.5%

Source: Bloomberg, Merrill Lynch, as at 3 September 2021.

Chart of the week: Falling US unemployment rate (4/20 – 8/21)



Source: Bloomberg, Columbia Threadneedle Investments, as at 6 September 2021.

Macro / government bonds

Government bond yields generally moved higher last week; the spectre of a withdrawal of ultra-easy policy conditions remains front and centre of attention.

Indeed, we will hear more on this subject perhaps this week from Europe when the European Central Bank meets on Thursday and might indicate the start of a slowing in PEPP purchases. This comes in the wake of inflation data that is running well ahead of target; albeit likely reflective of supply and labour shortages as economies reopen. That theme was also in evidence at the end of the week in the US where job creation significantly missed expectations, led by lower growth in the leisure, hospitality and retail sectors. However, wage growth headed higher to 4.5% y/y, while expectations were for a number less than 4%. The unemployment rate fell again to 5.2% **(see chart of the week)**. This took (negative) German bond yields higher to the loftiest level since mid-August. US yields are around 40+ bps higher this year led almost exclusively by rising inflation expectations in the first quarter.

In addition to the ECB meeting this week, we have Labor Day in the US today so it should be a quiet start to the week.

Investment grade credit

Weakness in government bond markets barely registered in credit market spreads last week. Over the last seven days the global IG index tightened by a basis point. Spreads, though tighter this year, remain steadfastly in a very tight range since the end of Q1,21. Last week saw a fairly heavy volume of new issuance, though lower than last year as the quiet summer period came to an end.

On a risk-adjusted basis, cyclicals stand out in performance terms with areas such as autos and basic materials tightening more on percentage basis than banks, telecoms, and media. Within banks, however, contingent capital (COCOs) have had an impressive year with spreads nearly 22% tighter while the global index itself is less than 11% better this year.

High yield credit

European high yield had a quiet firm week as spreads tightened 3bps to 310bps with CCCs strongly outperforming BBs (by 4x). The primary market basically remained shut, for the fourth week in a row, though with talk of the growing new issuance supply coming in the following weeks (as large as €40bn in bonds and loans to end of October.) The asset class remained in outflow mode with another €90m exiting, both in ETFs as well as in managed accounts. Trading was firm for much of the week as market participants appeared to be consolidating their positions in advance of the upcoming issuance.

On the M&A front, Ashland announced agreement to sell Ashland Adhesive Business to Arkema (French group) for $1.65bn in cash, while an element of shareholder return is also being discussed. In auto news, both manufacturers and OEMs are talking about the chip shortage problem extending into 2022, which could mean lower sales due to production issues.

Finally, another milestone week for European high yield: real yields turned negative for the first time ever.

Asian credit

Bharti Airtel has announced a rights issue that will raise $2.86bn (INR210bn) over a period of three years with an initial amount of 25%. The timing of raising the remainder of the amount will be co-ordinated with the company's funding requirement. The key shareholders, the Mittal family and Singapore Telecom, will collectively subscribe to the full extent of their aggregate rights entitlement and any unsubscribed shares. With regards to potential spending plans, management expects the spectrum auction for 5G to take place in early 2022.

Several regulators including the Ministry of Transport, Cyberspace Administration of China, the Ministry of Industry and Information Technology and SAMR have directed companies that are involved in the online car-hailing business to rectify their business misconduct and malpractices by December 2021. 11 companies including Didi, Meituan and Alibaba are required to address issues in competition, data security and labour management. Companies are also required to strengthen the recruitment process to weed out unlicensed drivers and to improve the channels for drivers' feedback.

Both Pertamina and Perusahaan Gas Negara (PGN) have reaffirmed their commitments to financially support PT Saka Energi Indonesia. PGN has also extended the maturity of the $361m shareholder loan to Saka Energi. The $77.6m tranche is extended for one year from January 2022 to January 2023, with a lower interest rate of 3.7% (previous: 6.4%). The $283m tranche was extended to December 2025.

Emerging markets

Peru was downgraded from A3 to Baa1 by Moody's due to enhanced political risk, following socialist Castillo taking office. Some market participants now expect Peru to accelerate rate hikes to 1% in an effort to curtail capital outflows and currency depreciation.

In Turkey Inflation rose further to 19.25% y/y, meaning real rates now stand at -25bps. The Treasury and Finance ministry have subsequently upgraded their year-end forecast to 16.2%. Despite this President Erdogan still hopes for an early rate cut.

PMI data showed South-East Asian low-cost manufacturing hubs of Vietnam, Indonesia and Malaysia were hard hit due to virus outbreaks and factory suspensions. Japan, South Korea, and Taiwan also saw slower growth in manufacturing activity, hampered by chip shortages.

Commodities

Natural gas prices rallied 7.4% to three-year highs, driven by the impact of hurricane Ida. As of Monday, 83% of offshore gas production remains offline and 863,000 homes were without power on Friday. The supermajors are currently assessing the damage; however, production is expected to be disrupted for at least a couple of weeks.

Agriculture fell by 2.2% on aggregate as key Louisiana export terminals have been without power. The ports of New Orleans and South Louisiana are two of the largest in the country by cargo volume; New Orleans itself is the biggest US agricultural trading hub. This comes as US ports in general are seeing shipping logjams and experiencing spiralling costs for ocean freight.

Responsible investments

An abundance of sovereign Green Bond issuance is due in the coming days and weeks, which could be a record-breaking amount. Chancellor of the Exchequer in the UK, Rishi Sunak, is expecting the upcoming UK Green Bond issuance to be the largest in the world. Spain, Columbia and the European Union are all on the list to issue as well, with early reports showing we could see at least €20bn in Green Bond issuance by the end of the month.

The Australian government is yet to agree to a net zero carbon emissions target. Per capita the country is the third-largest carbon emitter in the world with 60% of its power generation coming from coal. It has rejected bids for stronger climate targets and instead claimed it will invest in specific technology to reduce emissions. Pressure is mounting on the nation to agree to a net zero target ahead of the COP26 summit in a few months.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

6th September 2021

COLUMBIA THREADNEEDLE INVESTMENTS

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. ▪ Although credit spreads have widened slightly, they are still near all time tights and leave little room for the growth story to get derailed. 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. ▪ Uncertainty is rising as Delta threatens the recovery, monetary & direct fiscal support wane, and unemployment benefits expire.	▪ 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 Delta variant cases worsen and restrictions return, threatening returns to schools, offices and travel 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, with the exception of countries aggressively hiking rates (like Russia and Brazil).	▪ 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. ▪ IG has been historically resilient in the face of inflation, even if other sectors may benefit more from it. ▪ Good fundamentals after most recent earnings, with strong balance sheet management and deleveraging from capital management & sales growth	▪ 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	▪ The Fed has been the 1000lb gorilla in this market since COVID hit, and it is progressively getting closer to tapering. The Fed will taper MBS alongside USTs, but tapering will still be a headwind to the market. Banks, the other major buyers, have slowed their purchases as well. ▪ With interest rates falling again, fundamentals worsen as prepayment speed will remain elevated. Changes to FHFA housing policies could also be marginally negative for fundamentals over time.	▪ 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. ▪ 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: favored bonds are still 'story' bonds. A return to normal won't look 'normal' for sectors like office space or convention hotels and recently has lagged. ▪ 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 ▪ u/w Livestock ▪ u/w Gold ▪ o/w Soybenas	▪ US China trade war ▪ Renewed Covid lockdowns

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