COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

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Commodities
Emerging Markets

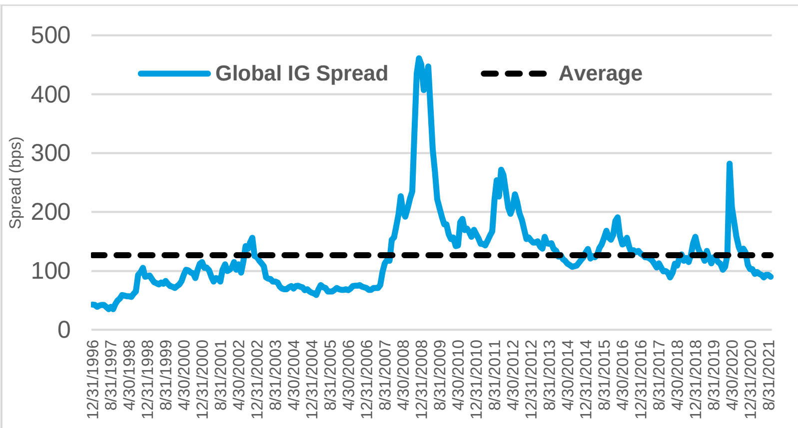
Autumn leaves (and bond prices) start to fall.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.49%	4 bps	0.4%	-2.3%
German Bund 10 year	-0.21%	2 bps	0.2%	-2.7%
UK Gilt 10 year	1.03%	10 bps	0.1%	-7.6%
Japan 10 year	0.05%	-1 bps	0.2%	0.1%
Global Investment Grade	91 bps	2 bps	0.3%	-2.5%
Euro Investment Grade	85 bps	2 bps	0.1%	-0.3%
US Investment Grade	89 bps	2 bps	0.4%	-0.7%
UK Investment Grade	88 bps	2 bps	0.0%	-3.4%
Asia Investment Grade	197 bps	0 bps	0.1%	0.1%
Euro High Yield	320 bps	17 bps	-0.1%	3.6%
US High Yield	320 bps	15 bps	0.0%	4.7%
Asia High Yield	704 bps	-34 bps	0.1%	-6.2%
EM Sovereign	330 bps	10 bps	0.0%	-1.6%
EM Local	5.3%	9 bps	0.3%	-6.1%
EM Corporate	305 bps	6 bps	0.0%	1.6%
Bloomberg Barclays US Munis	1.1%	10 bps	0.0%	0.8%
Taxable Munis	2.2%	2 bps	0.4%	1.2%
Bloomberg Barclays US MBS	26 bps	-4 bps	0.2%	-0.5%
Bloomberg Commodity Index	216.77	2.0%	0.2%	29.3%
EUR	1.1612	-1.1%	0.1%	-5.1%
JPY	111.25	-0.3%	0.2%	-7.0%
GBP	1.3582	-1.0%	0.5%	-0.9%

Source: Bloomberg, Merrill Lynch, as at 4 October 2021.

Chart of the week: Global Investment Grade Spread (1996-2021)



Source: Bloomberg, Columbia Threadneedle Investments, as at 4 October 2021.

Macro / government bonds

September will not be remembered as a particularly happy month for either bond or equity markets. A series of negative developments affected markets: the problems at Evergrande in China prompted a degree of risk aversion and fears of contagion; surging energy prices and consequent rising inflationary fears were augmented by more hawkish rhetoric from central banks (including the US Federal Reserve and Bank of England); and the ongoing level of Covid-19 Delta variant cases also undermined market confidence.

Central Banks continued to maintain that rising inflation is transitory and reflects disruptions to supply chains, which will abate in due course (2022) and which would not need to result in a meaningful tightening in policy conditions. Another market debate is whether these rising energy prices and supply chain issues will prove harmful to economic demand or lead to rising inflation (wage response etc). The risk of some form of stagflation has, therefore, become a theme.
The net effect of this market background has been for government bond yields to rise through the month with European and UK rates markets underperforming their US counterparts. US Inflation expectations were only marginally higher in the month but more meaningfully so in Germany (+20bps) and the UK. In the US, the sell-off was driven more by a rise in real yields; the US dollar was the chief beneficiary and strengthened to the highest level is a year versus the euro.

Investment grade credit

Rising bond yields have affected equity markets negatively but been a bit of a 'non-event' for investment grade corporate bonds. Spreads remain little moved, as has been the case in recent months. In September, the ICE BoAML Global Index spread was only 3bps tighter; however, this was not enough to save the market from negative returns. Rising government bond yields more than offset the effect of tightening spreads, meaning that total returns were the worst since February 2021 at around -1%. For the third quarter, the market return was fairly flat.

This year US credit markets have outperformed with spreads now around 17% tighter whereas the European market has only moved around 11% better. Most of this tightening occurred at the start of the year.

We retain a neutral view in terms of the outlook for spreads. We feel that despite a little more hawkishness from central banks, policy conditions are likely to remain supportive for the market into the coming quarter. Meanwhile, although growth is expected to ease from the pace recorded in Q2, GDP data will remain positive. This 'not too hot, not too cold' environment is also a healthy background for the investment grade market. Our credit analyst team expects corporate credit quality to continue to improve and to be broadly similar to how we were at the end of 2019 by late this year. For banks, we expect an improving/falling 'cost of risk' with 'normalisation' achieved by 2022. Margins are likely to remain under pressure, however, and capital ratios are likely to decline, albeit to remain at healthy/strong levels while loan growth is expected to remain fairly modest in Europe and the US. All the while market issuance is expected to remain below the levels seen last year while demand for income generating assets remains a positive force.

So why aren't we more bullish? The problem really is one of valuations (spreads) and how those rest in the historical context. At present, Global IG spreads are around 0.7 standard deviations rich to a 20-year average and more so over shorter time periods (5 years): **see chart of the week**.

High yield credit

US high yield bond prices declined over the week amidst the continued rise in US rates and equity volatility weighing on investor sentiment. The ICE BofA US HY CP Constrained Index fell -0.29% over the week and spreads were 15bps wider. The index yield-to-worst increased to 4.01%. According to Lipper, inflows were modest with a net $196m contribution. Supply increased with the long-anticipated Medline funding coming to market, representing the seventh largest high yield issuance at $7bn. Despite this, September's issuance of $43.7bn still fell short of expectations and prior year issuance of nearly $51bn. For the month of September, the asset class delivered its 12th consecutive positive total return, albeit the lowest over the period at 0.03%.

European high yield posted another negative week with BB performing marginally worse than CCC rated credits. September was the asset class's first negative return month in 12 months. The asset class experienced a very small inflow due to managed accounts. The primary market was slower than the previous week with only around €2.4bn, with single B securities dominating.

There was more M&A news with Rolls Royce announcing the sale of ITP Aero to a private equity consortium for €1.7bn. This is the main part of a £2bn disposal plan that had long been flagged to the market. In leisure, Scientific Games announced the sale of its sports betting Openbet business for $1bn cash and $200m in stocks. Again, this is another case of an asset sales plan with proceeds to reduce cash. There was news out of French retailers with talk of megastore Carrefour looking at buying competitor Auchan. Finally, Coty announced selling 9% stake in Weller (sold 60% to KKR last year) with proceeds to be used to redeem KKR's equity.
In airlines news, Lufthansa announced that ticket demand is almost back to pre-crisis levels. On the auto sector side, auto companies are now talking about a chip shortage recovery, but with normalisation only after H1, 2021.

It's been noted that with inflation figures higher than they have been in a while, that on a real yield basis, 80% of European high yield bonds now trades with a negative yield.

Leveraged loans

Leveraged loans were more resilient over the week, with the average price of the J.P. Morgan Leveraged Loan index increasing $0.07 vs the high yield bond decline. Inflows continued with a $331m contribution over the week, albeit at a level well below the year-to-date average. For the month of September, the index provided a +0.69% gain, with Split B/CCC loans (+1.44%) outperforming B (+0.67%) and BB-rated issuers (+0.54%). Leveraged loan returns outpaced high yield bonds by 66bps in September, the largest outperformance since January.

Structured credit

The Agency MBS market had a strong week, up 15 bps and outperforming other high quality bond sectors. Once interest rates stabilised after the 10 year broke through 1.50%, mortgage buyers came back in to take advantage of lower prices and less volatility. The outperformance was across the coupon stack but as MBS current coupon yield briefly hit 2% yield buyers stepped in in size for the retrace. For the month of September, supply in Agency MBS was roughly $7.6bn/day on average, in-line with the prior month. On the demand side, the Fed purchase schedule saw an increase of c500 million additional mortgages per day given higher pay downs, which kept mortgages well supported. In CMBS, spreads held in last week despite heavier supply. Mezzanine risk outperformed and SASB new issuance shifted to more Office and Multifamily away from Hotels. For September, the delinquency rate declined for the 15th consecutive time to 5.49%, which was the largest drop since the Global Financial Crisis. The special servicing rate fell to 7.32% and modifications stood at 6.84%.

Asian credit

The authorities at Zhuhai city (Guangdong Province), the gateway to Macao from Mainland China, has extended the 14-day mandatory quarantine from travellers coming in from Macao. This quarantine measure was imposed on 26 September due to a Covid-19 community outbreak in Macao. This travel restriction is negative for the GGR (gross gaming revenue) in Macao during the Golden Week holidays from 1 October to 7 October 2021.

On 29 September, Evergrande Group announced the divestment of a 19.93% stake in Shengjing Bank for around $1.5bn to Shenyang Shengjing Finance Investment Group, a state-owned asset management company. This transaction will reduce Evergrande's stake in Shengjing Bank from 34.5% to 14.57%. Evergrande is still working to sell its stakes in various businesses such as Hengten Networks, Evergrande Property Services, Evergrande New Energy Vehicle Business, Evergrande Life Insurance and Evergrande Spring (mineral water, grains, oil and dairy).

Emerging markets

Asian markets declined on Monday morning as Evergrande shares halted trading. The company revealed it was expecting a potential offer for its property management business. Smaller Chinese developer Fantasia Holdings saw bonds trading at 39 cents on the dollar ahead of a $208m debt repayment on Monday.

The Czech Republic hiked rates 75bps; this hike aims to temper business and public concern of overshooting inflation. Eastern European economies have been more exposed to the recent gas price rises due to a higher CPI weighting.

Elsewhere in central bank news, Mexico and Colombia hiked rates 25bps to 4.75% and 2.0% respectively

Commodities

Commodities rallied 2% on the week driven by the ongoing energy shortage in China and Europe.

Base metals were down 3.5% on aggregate due to Chinese factory closers. Closures were driven by both power shortages and Beijing-imposed energy limits to promote efficiency. Nickel and Tin were the worst performers down 7.4% and 7.3% respectively.

Energy markets rallied 4.8% overall led by Natural gas, which surged 8.0%. European gas prices have now rallied 300% this year as competition for LNG from Asia has driven prices higher. In the UK more than 2,000 petrol stations are now dry. In China, coal producers have been told to exceed quotas and the government has vowed to do everything that's needed to ensure winter supply is adequate.

Responsible investments

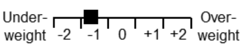
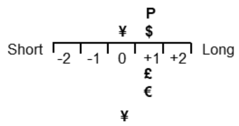
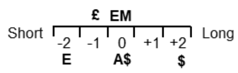
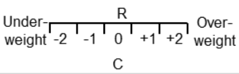
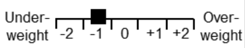
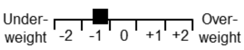
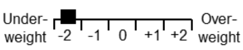
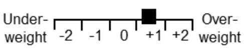
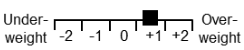
Sales in Sovereign ESG bonds broke records in September. In addition to the UK's $13.5bn Green bond issue we saw in mid-September, a total of $27bn was issued by sovereign states including Serbia, Germany, Chile, Spain and Columbia.

Total ESG bond issuance for Q3 across the market may not have been as much as we've seen in the previous quarters of this year, but it does show a promising sign of the market reaching $1trn by the end of 2021. The European Union is, again, due to issue further green bond issuance this month, pushing it towards the top of the list for becoming the largest issuer of environmental debt.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

4th October 2021

Strategy and positioning (relative to risk free rate)		Views	Risks to our views
Overall Fixed Income Spread Risk		▪ 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)		▪ Yields have broken out of their earlier tight ranges but likely to remain capped by structural downtrend in real yields and growth ▪ 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	▪ Inflation becomes more persistently entrenched, warranting much higher rate structure ▪ 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)		▪ The US leads the way on the economic recovery from the pandemic, which drives a monetary wedge between the Federal Reserve and ECB ▪ Window for dollar underperformance has narrowed as central banks globally turn more hawkish on inflation expectations at the expense of growth	▪ Re-acceleration of global growth forecasts led by reversal of China credit contraction ▪ US fiscal push fades
Emerging Markets Local (rates (R) and currency (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)		▪ 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		▪ 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		▪ 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		▪ 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		▪ 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		▪ o/w Copper & Lead vs Zinc ▪ u/w Livestock ▪ u/w Gold ▪ o/w Soybeans ▪ o/w Oil	▪ US China trade war ▪ Renewed Covid lockdowns