COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

17 JANUARY 2021

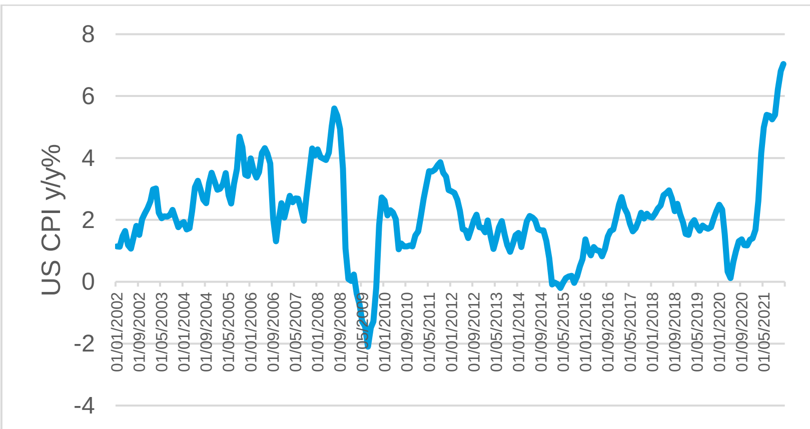
Inflated inflation, fuels rates fears.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	1.78%	2 bps	-1.8%	-1.8%
German Bund 10 year	-0.04%	1 bps	-0.7%	-0.7%
UK Gilt 10 year	1.17%	-1 bps	-1.7%	-1.7%
Japan 10 year	0.15%	1 bps	-0.5%	-0.5%
Global Investment Grade	100 bps	3 bps	-1.6%	-1.6%
Euro Investment Grade	99 bps	3 bps	-0.6%	-0.6%
US Investment Grade	97 bps	2 bps	-2.1%	-2.1%
UK Investment Grade	95 bps	0 bps	-0.9%	-0.9%
Asia Investment Grade	191 bps	9 bps	-1.2%	-1.2%
Euro High Yield	333 bps	5 bps	0.0%	0.0%
US High Yield	309 bps	-11 bps	-0.8%	-0.8%
Asia High Yield	787 bps	92 bps	-6.3%	-6.3%
EM Sovereign	342 bps	11 bps	-2.6%	-2.6%
EM Local	5.9%	2 bps	0.2%	0.2%
EM Corporate	310 bps	9 bps	-1.2%	-1.2%
Bloomberg Barclays US Munis	1.3%	6 bps	-0.9%	-0.9%
Taxable Munis	2.6%	2 bps	-2.2%	-2.2%
Bloomberg Barclays US MBS	36 bps	5 bps	-1.5%	-1.5%
Bloomberg Commodity Index	221.15	2.2%	4.4%	4.4%
EUR	1.1426	0.4%	0.4%	0.4%
JPY	114.45	1.2%	0.8%	0.8%
GBP	1.3672	0.6%	1.1%	1.1%

Source: Bloomberg, Merrill Lynch, as at 17 January 2022.

Chart of the week: US consumer price inflation (y/y%), 2002-22



Source: Bloomberg, Columbia Threadneedle Investments, as at 17 January 2022.

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Macro / government bonds

After a dismal start to the year, government bonds enjoyed a period of stronger performance last week up until Friday when yields rose once again. It seems concerns about tighter monetary conditions in the US are now well understood and discounted in prices. Interestingly, inflation expectations have fallen this year by around 20bps even as real yields have been under more pressure.

Last week also brought key consumer and producer price inflation data in the US. The headline rate of annual increase in both looks horrendous (7% for CPI and nearly 10% for PPI): **see chart of the week**, but this was no worse than expected and consequently did little to upset markets further. Concurrently, a raft of US Federal Reserve speakers sought to cement the notion of a near certain rate rise in March. Most market forecasters estimate that there will be between three and four rate rises this year in the US. It seems increasingly likely that the central bank will also start to dismantle its balance sheet of bonds in the second half of the year. This is likely to be achieved by not reinvesting maturing debt as it rolls off. Around 20% of the Fed's assets are below one year in maturity. The week ended with weak retail sales data.

Elsewhere, the UK produced a very strong GDP report for November (+0.9%) that lifted the economy to a size greater than pre-pandemic for the first time. Unfortunately, we expect December's report will be weak and reflect the effects of the Omicron spread. On that front, case counts in the country, seen as a lead indicator, are down by around a quarter in the last week which is encouraging.

This week should begin rather quietly as there is a holiday in the US on Monday and the US central bank enters a 'blackout' period ahead of the FOMC meeting next week.

Investment grade credit

Credit spreads drifted a little last week with the global index spread now back to three digits. All the while, it was another five days of heavy issuance, which weighed on the market.

In company specific news, French state-owned utility EDF dropped its leverage and earnings guidance for 2022 due to the government's decision (ahead of elections) to postpone tariff increases, open a higher proportion of EDF's generation competition, on top of fresh nuclear powerplant outages. Bonds were weaker on the news. There will be more details to follow mid February with results.

In the US, at the end of the week, JP Morgan, Citibank, and Wells Fargo delivered what were in our view 'solid' numbers. A benign credit environment saw the companies benefit from write backs, increased margins and most notably strong loan growth. Return on equity is now higher than was the case pre-pandemic.

Lastly in the UK, Unilever appears to be prepared to offer a substantial amount of money for the consumer healthcare business of GlaxoSmithKline. A figure of around £50bn has been touted in the weekend press.

High yield credit & leveraged loans

US high yield bond prices round tripped as the week progressed as buyers emerged following a sharp increase in yields to begin 2022. Fed expectations have recalibrated following the hawkish minutes and strong labour market report with investors now largely anticipating a first hike in March and four cumulatively in 2022. While prices are down in response to rising treasury yields, spreads are relatively steady and are not far above late-December's multi-year tights. The ICE BofA US HY CP Constrained Index returned 0.12% over the week and spreads were 11bps tighter, ending the week at +324bps.

The average price of the J.P. Morgan Leveraged Loan index continued to rise this week as demand for floating rate debt has benefited from a resetting of Fed expectations. Leveraged loan funds reported a $1.84bn inflow over the past week, which was the second largest weekly inflow on record for the asset class behind only 8/7/13's $1.87bn. The leveraged loan index has returned +0.50% in January, which compares to losses for high yield and investment grade bonds totaling -0.82% and -2.11% as a sharp rise in rates boosts demand for floating-rate product.

After the strong start of the year, European high yield showed some consolidation last week with a soft tone in the market as spreads widened and yields rose. CCCs outperformed BBs while Bs barely outperformed the higher rated credit. Flows continued to be positive for the year, both for ETFs and managed accounts, though at a much smaller scale than the previous week (+€68m). Primary market pace picked up, albeit still at a subdued pace for this time of the year, with only two deals (United Group and Tereos) for a total of €850m. Market pricing is proving more demanding as the United Group deal came in 25bps higher than the initial price talk. The pipeline is expected to build up in the coming week given the forecast of €10bn of issuance in January and the start of February. The market continues to be cautious for longer duration bonds given rising rate concerns. Credit rating changes last week, included the downgrade of Elior, the French catering business, to B from Ba3 by Moodys. They cited prolonged Omicron impact delaying people's return to the office and expectations that this will weigh on the food service business, delaying a return to profitability.

In telecom news, it was reported that KKR has approached the Saudi sovereign wealth fund to consider taking part in KKR's bid for Telecom Italia. In utilities, EDF announced a massive profit warning with a potential drop on EBITDA of c€8bn due to both lower nuclear output but more importantly due to the impact from government-imposed tariff restrictions.

Asian credit

The Macau government has announced amendments to the new Gaming Law which help to mitigate concerns about adverse regulatory intervention and oversight. The announcement highlighted a maximum of six gaming license which ease concerns that one or more of the six incumbent concessionaires could lose their concessions. The period of each new concession is 10 years with the potential extension of three years and there are no changes to the tax.

Fitch downgraded Guangzhou R&F to Restricted Default following the completion of its tender offer and consent solicitation which is viewed as a distressed exchange. Yuzhou Group is seeking an exchange of two of its 2022 senior notes and amendments to the indentures for several bonds to avert default. Sunac plans to raise $580m (HKD4.52bn) of gross proceeds via share placement to the family trusts of Sun Hongbin (Chairman of the Board and an Executive Director of the Company). Shimao Group is reportedly negotiating with investors to repay CNY1.17bn ($183m) of ABS in instalments through 2022.

Emerging markets

Weakness in EMD continued, as sovereign and corporates spreads widened for a second week in a row. The asset class reverted back to outflows, resulting in net outflows, year-to-date, as hard currency funds experienced their largest outflow in a week since early October. This was in contrast to the inflows seen for local currency funds, both for China focused funds as well as EM ex-China funds. This broke a 10-week streak of outflows for local currency funds. The primary market took a bit of a battering as a number of new issues were poorly received.

The global rate hike trend continues with last week interest rate hikes in Korea (+25 bps to 1.25%) and Romania (+25 bps to 2.0%).

Rating downgrades last week as Fitch downgraded Ghana to B- from B. This brings the country's credit rating in line with Moody's and S&P. This followed the downgrade of Sri Lanka, by S&P, to CCC from CCC+, bringing it in line with Moody's.

In Kazakhstan, the unrest of the start of the year is beginning to quiet down. A number of officials in key government posts have resigned and the Russian troops have left. The human toll has been high with over 200 people dead and almost 10,000 people detained. In Ukraine, the risk of Russian sanctions remain high as the impasse continues between the US and Russia.

Commodities

Robust performance for commodities, last week, as the market returned 2.3%. Again, another week that was largely energy led (+6.5%), as oil prices rose almost 6% with Brent reaching $86+/barrel. US/ Russian tension continued to increase, pushing Brent price higher. This was even as Libya brought oil production back on line, reaching 1 million barrels/day, after being shutdown for three weeks. OPEC capacity continues to shrink, keeping the market fairly firm. Natural gas was up almost 9% as heavy winter weather blanketed the Midwest, and moved eastwards.

Base metals were stronger, led by Nickel this time (+7%), but still with positive performance from Aluminium (+2.1%) and more modest gains from copper (+0.8%). Precious metals were also higher with gold (+1.2%), again, breaking though $1800/oz with silver up almost 3%. Only agriculture was lower (-1.5%) as grains were lower (-2.4%) with soy beans, corn and wheat retreating, after the sharp rise the previous week.

Responsible investments

Issuance for specific use of proceeds bonds has now started to pick up after taking a Christmas break, with $50bn of debt already raised this year. Some investors are anticipating this year to be another record breaker for issuance, as Green, social and sustainability bonds totalled just shy of $1trn for the full year of 2021, over double of that from 2020 ($466bn), according to Bloomberg.

In another view of issuance in 2021, according to Bloomberg, banks took more in fees from issuing Green bond related debt than they did from helping raise money for fossil-fuel companies. In total for 2021, $3.4bn was taken in fees for Green bond issuance compared to $3.3bn for deals with oil, gas and coal companies. In contrast, for 2020 only $1.9bn was taken for Green bonds versus $3.7bn for fossil fuels.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

17th January 2022

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	■ 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 economic growth and central bank accommodation. The pullback in forecasted liquidity has left opportunity for market volatility. ■ Uncertainty remains elevated as the Omicron variant spreads, inflation fears revive, supply disruptions continue, 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: Omicron worsens. Supply chain disruptions and inflation fears continue into 2022. 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 £ €	■ Carry offered by front end yields now attractive ■ Longer yields continue to be capped by long-run structural downtrends in real yields ■ Inflation likely to normalize over medium term ■ Hiking cycles to be shortened by easing inflation and moderating demand ■ ECB to lean against rising financing rates	■ Inflationary dynamics become structurally persistent ■ Labour supply shortage persists; wage pressure becomes broad and sustained ■ Fiscal expansion requires wider term premium ■ Long run trend in safe asset demand reverses
Currency ('E' = European Economic Area)	¥ EM A$ Short -2 -1 0 +1 +2 Long $ £ E	■ There is room for the Dollar to strengthen further given our belief in the US leading the economic and monetary policy recovery ■ However, experience of past cycles suggests the Dollar fares less well at the start of a cycle, turn neutral USD for now	■ The ECB moves to tighten monetary policy ■ The Fed starts to push back against market pricing ■ More expansive China credit cycle
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ Selective opportunities ■ 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 ■ Tightening global financing conditions
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	■ Valuations are getting increasingly more attractive ■ 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).	■ Spillover from China's credit woes ■ 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 Bonds and Bank Loans	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 Runway left in HY recovery trade rising stars ■ Bank loans continue to be a more attractive part of the show better valuations relative to corporates. ■ 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, although mounting negative headwinds (inflation, supply disruptions) are increasing pressure for higher yields. ■ 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's taper was well advertised and saw a muted market reaction upon official announcement. ■ Valuations remain extremely rich, with unattractive carry in many Specifies Pools and CMO deals ■ 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. ■ Uncertainty the Fed taper schedule and long-term position
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ Our preference remains for non-agency RMBS in this area. ■ Opportunities with repricing risk premiums in new issues ■ 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.	■ Attractive shorter duration deals coming into market, provide less carry ■ 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 Oil ■ o/w Natural Gas	■ US China trade war ■ Renewed Covid lockdowns ■ Global Recession

Important information: For use by Professional and/or Qualified Investors only (not to be used with or passed on to retail clients). Source for all data and information is Bloomberg as at 17.01.2022, unless otherwise stated.

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