COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

21 MARCH 2022

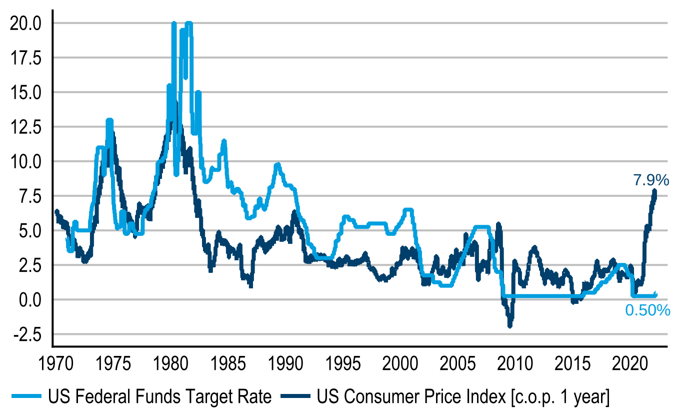
Hawkish Fed, dovish Bank.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	2.18%	19 bps	-2.1%	-4.7%
German Bund 10 year	0.40%	15 bps	-1.5%	-3.7%
UK Gilt 10 year	1.53%	4 bps	-1.3%	-6.6%
Japan 10 year	0.21%	2 bps	-0.2%	-1.4%
Global Investment Grade	142 bps	-9 bps	-2.0%	-6.6%
Euro Investment Grade	148 bps	-6 bps	-1.0%	-4.9%
US Investment Grade	137 bps	-13 bps	-2.4%	-7.5%
UK Investment Grade	130 bps	1 bps	-1.0%	-5.9%
Asia Investment Grade	237 bps	-8 bps	-2.4%	-5.5%
Euro High Yield	450 bps	-19 bps	-0.6%	-5.1%
US High Yield	381 bps	-24 bps	-1.4%	-4.9%
Asia High Yield	984 bps	-13 bps	-7.4%	-15.2%
EM Sovereign	399 bps	-30 bps	-0.8%	-9.0%
EM Local	6.1%	-4 bps	-2.5%	-7.4%
EM Corporate	408 bps	-19 bps	-1.8%	-8.2%
Bloomberg Barclays US Munis	2.3%	12 bps	-1.9%	-4.9%
Taxable Munis	3.3%	17 bps	-4.9%	-9.1%
Bloomberg Barclays US MBS	28 bps	-2 bps	-1.6%	-4.0%
Bloomberg Commodity Index	267.84	-2.4%	7.7%	24.5%
EUR	1.1052	1.3%	-1.5%	-2.8%
JPY	119.19	-1.5%	-3.5%	-3.4%
GBP	1.3144	1.1%	-1.8%	-2.6%

Source: Bloomberg, Merrill Lynch, as at 21 March 2022.

Chart of the week: US CPI vs Fed Policy Rate



Source: Macrobond, Columbia Threadneedle Investments, as at 21 March 2022.

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Macro / government bonds

Last week, the US Federal Reserve embarked on the road to normalising monetary policy conditions. As widely expected, interest rates were moved higher by 25bps in the first tightening since 2018. Members of the Federal Reserve Open Market committee also estimate that there will be a further six interest rate rises in the present year and more in later years taking the funds rate to 2.75% at its peak by 2023. In terms of economic and inflation projections, the Fed foresees growth as a little lower than it thought last December but inflation higher and coming in around 4% by the end of this year before gradually declining towards 2.3% by the end of 2024 (still a little above target though). As mentioned, much of this was already expected and discounted in bond prices. Hence, the reaction was a little muted, especially after the recent sell off in core bond markets. In testimony, Fed Chair Powell noted that the risk of recession in the US was not particularly elevated, and the economy is very strong at present.

The Bank of England followed its US cousin with a 25bps increase in the base rate (and the third in its own tightening cycle) to 0.75%. This brings policy rates back to pre-Covid levels. Market pricing is for UK rates to peak at around 2.3% over the course of the next couple of years and to reach 2% by the end of 2022. As in other jurisdictions, consumers face significant hurdles to spending in the coming months. Fuel bills have rocketed, food prices are rising while tax bills will follow suit at a time when interest bills are also increasing. These factors have led the Bank to indicate that it is likely future tightening will be more modest in speed and extent to that of the US. This news was received well by the gilt market and helped steepen the UK yield curve.

Investment grade credit

Risk market sentiment improved materially towards the end of the week. There were a couple of exogenous reasons for the improvement. Firstly, there are signs of progress in talks between Russia and Ukraine. A suggestion that Russia might permit Ukraine to retain an army if it promised neutrality gathered attention and recognition from both sides. Secondly, comments in China that the government was focused on policies to support markets allayed fears of financial collapse and the contagion that might spread to all markets.

As a result, global spreads which have widened from around 100bps at year end to 153bps by mid-March tightened to end the week at 142bps. For context spreads are close to the long-term average.

High yield credit & leveraged loans

US high yield valuations were sharply tighter over the week as the Fed delivered some clarity arounds its policy path forward. Having cleared the much anticipated Fed lift-off, policy is now “likely” as hawkish as it gets with the median participant expecting seven hikes through year-end and policy rates in restrictive territory by next year. The ICE BofA US HY CP Constrained Index returned 0.51% and spreads were 25bps tighter. Meanwhile, the high yield primary market remains subdued, with two deals totalling $800m priced over this week and only nine deals totaling $4.2bn pricing over the last four weeks, the lightest pace of activity since the onset of the pandemic in March 2020. According to Lipper, outflows continued with a $1.6bn withdrawal from retail funds over the week, leaving YTD outflows at nearly $24bn.

Leveraged loan prices recouped more than a third of the previous two weeks’ setback as investors responded favourably to the Fed’s much anticipated lift-off on Wednesday. Specifically, the average price of the J.P. Morgan Leveraged Loan Index increased +$0.63, recovering more than one-third of the -$1.75 decline over the previous nine sessions. Loans experienced their first weekly retail fund outflow since December with a $518m withdrawal. YTD inflows total $16bn for the asset class.

European High Yield (EHY) had its first week of positive performance since early January 2022, as the spread tightening of the previous week continued. EHY spreads, now in the mid 400bps, are 45bps lower from the high of early March. CCCs outperformed the higher rated credits. Liquidity remains thin, amplifying some of the market moves. The market has moved from, at times, a challenging environment to sell, to a challenging environment to buy as short covering trading, especially for very beaten-up names, means it can take some time to get buy orders executed. Outflows continued for the asset class, with €653m exiting both via ETFs and managed accounts. The primary market is still shut due to the market liquidity. Talk of shelving / delaying fund raising deals is starting to hit the market, putting a hold on potential new issues.

In credit rating news, Moody's downgraded Eircom, an Irish telecom, to B2 (stable) from B1 on the back of the partial network sale to Infravia on concerns over structural subordination. There was also an update on Pro-Gest, the Italian paper products manufacturer, who we reported last week as having to shut down some paper mills due to high energy costs. A few days after the news, the company announced that it had restarted operations, but changed the output product. Its bonds rose on the news but only partially recovered some of the earlier sell off.

On the M&A front, Solvay, the Belgium chemicals company, reported it is in discussions to break up the company into two: one focused on commodity chemicals and the other on specialty chemicals.

Structured credit

The US Agency MBS market had another tough week, down 54bps in total return. Performance was fairly stable post the FOMC meeting; however, OAS across many coupons was wider as rates sold off. The trend in spreads is wider yet as the market looks for more information from the Fed as to the timing and pace of its balance sheet unwind. On the technical front, we are starting to see international investors stepping up their net purchases, which is a positive. CMBS continues to be under pressure. While outperforming corporates, spreads are wider across the stack and new supply has been significantly higher. Macro risk has been weighing on investor appetite as the sector's beta is similar to high yield. In CLOs, we had the biggest AAA BWIC in history last week at over $900m, which the market had no issue taking down. That said, spreads ended the week slightly wider overall. The average discount margin over Libor sits at 138bps and the average price is just south of $99.

Asian credit

The State Council of China provided assurances of market stability and support during a meeting of the Financial Stability and Development Committee. Monetary policy will remain proactive, which suggests further easing over the coming months. Additionally, the State Council reiterated that China will continue to support overseas share listings and maintain good dialogue with the US SEC over ADRs. This came on the back of the SEC's announcement about a provisional list of five Chinese companies that could face delisting under the Holding Foreign Companies Accountable Act (HFCAA). On a related note, the China Securities Regulatory Commission communicated its expectation that both US and China will be able to jointly work out co-operation arrangements that comply with the legal and regulatory requirements of both countries to promote the stability of the capital markets.

The State Council also said that the rectification of the big internet platform companies will be completed as soon as possible through transparent and predicable regulation. On the property sector, the State Council highlighted the importance of effective risk prevention and mitigating measures to support the transformation to a new development model.

In India, the Andhra Pradesh High Court issued an order that the state discom (electricity distribution company) must honour the terms of the power purchase agreements (PPAs) with the renewable energy companies. The High Court also ruled that the fixed tariffs of the PPAs are not negotiable without the consent of both parties. This is a credit positive development that can lower the receivables days for the renewable energy companies, especially Greenko and ReNew Power.

Emerging markets

Russia has paid $117m in coupon payments on US dollar denominated 2023 and 2043 maturity Eurobonds. The move signals both the ability and willingness of Russia to honour its hard currency debts and comes after the Russian central bank announced a temporary ban on coupon payment to foreign owners of ruble-denominated bonds.

China is considering extending a $1.5bn credit facility and a $1bn loan to Sri Lanka, which is currently in the midst of a financial crisis. Sri Lanka has suffered from declining tourism revenue, low foreign exchange reserves and is struggling to import basic goods. Millions of exams have been cancelled for students due to a shortage of printing paper. The crisis has only been exacerbated by the Russia / Ukraine crisis given Sri Lanka imports 45% of their wheat from Russia and Ukraine. Both countries are also key export markets for Sri Lankan black tea.

In Peru, the top constitutional court ruled former president Fujimori can be freed from prison following being sentenced for human rights violations in 2017. S&P downgraded Peru to BBB from BBB+ referencing both the presidential deadlock and the potential impeachment as undermining efforts for a more robust growth outlook.

Egypt hiked rates for first time since 2017 by 100bps to 10.25%. Egypt is experiencing soaring commodity and energy prices; Russian and Ukrainian wheat accounts for 70% of Egyptian wheat imports. Egypt is in talks with the IMF on possible support measures that could include a loan.

Elsewhere in central bank news, Brazil hiked rates by 100bps and Taiwan hiked by 25bps.

Commodities

Nickel was down 23% on the week following the 65% rally in the previous week. LME trading for nickel restarted on Wednesday and traded limit down (the maximum the LME will allow prices to fall) every day. As of Monday morning, Nickel is down by the 15% limit.

Brent traded down 3.4% last week but has rallied above $111 this morning on the news that the EU is considering joining the US on the Russian oil embargo. There was also another attack on a Saudi Aramco energy terminal by the Houthi militants, who are allegedly backed by Iran.

Responsible investments

Following Russian aggression in Ukraine the EU has recently announced plans to reduce reliance on Russian gas, which currently accounts for 40% of EU supply. The initiative REPowerEU aims to reduce reliance on Russian gas completely by 2030 and by two-thirds by the end of this year. A key focus of REPowerEU will be increasing imports of liquefied natural gas and accelerating the development of renewable sources, by simplifying and shortening permitting procedures. A short-term option could utilise coal power, which is currently the cheaper option in Germany. However, according to the IEA, running existing coal plants at full capacity and postponing retirements could increase EU greenhouse gas emissions by 8%.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

21st March 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	▪ Credit spreads have widened during recent volatility, which has been paired with neutral to worsening technicals and stable fundamentals in most sectors. This has created more pockets of opportunity, along with the deleveraging & upgrade stories. ▪ We are past the peak of economic growth, with first hike announced at the March FOMC meeting and expectations for many more. Pullback in forecasted liquidity created opportunity for market volatility. ▪ Uncertainty remains elevated due to fears surrounding pace of central bank hiking, inflation, recession probabilities, and the Russian invasion of Ukraine.	▪ Upside risks: lowered volatility once expansionary environment is established as the new normal ▪ Downside risks: more spillover from Russian invasion, sanctions difficult to remove post-conflict. More Covid variants emerge. Supply chain disruptions and inflation persist to H2 2022. Simultaneous low unemployment, hiking and slowing growth could cause a recession. Persisting commodity shocks
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	▪ 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	▪ The invasion of Ukraine will hit global growth, hinder risk markets and lend a bid to the Dollar ▪ The associated impact of higher inflation on central banks is uncertain, but is more likely to see a dovish repricing of the ECB than the Fed, we turn neutral on the Euro	▪ The ECB becomes concerned around potential second round effects and presses on with policy normalisation
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	▪ Russia/Ukraine conflict cautions against aggressive positioning ▪ Aggressive Fed pricing may now open the door to selective EMFX performance ▪ EM real interest rates relatively attractive, curves steep in places	▪ Negative sentiment shock to EM fund flows ▪ 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 more attractive, although for reason ▪ Russian invasion is primary story, as pressure from commodity price shocks, retail fund outflows, spread widening spillover and general uncertainty is felt across EM. ▪ Market-wide shock has created opportunities as some widening cannot be justified by fundamentals (esp. energy) ▪ DM tightening financial conditions will unevenly impact EM credit and EMFX as many countries have already responded to inflation through hikes	▪ Continued spillover from Russian invasion: local inflation (esp. food & commodity), slowing growth ▪ A replay of 2013 occurs with a taper tantrum or swift appreciation of the USD ▪ Persisting COVID growth scars hurt economies & fiscal deficits ▪ Weakening technicals with large fund outflows and slower supply
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ US and EMEA spreads have crept significantly wider, creating buying opportunities for favored sectors ▪ Robust new issue supply is seeing large concessions, despite absence of credit quality concerns ▪ IG has been historically resilient in the face of inflation, which has been broadly supported by earnings. ▪ Good fundamentals with strong balance sheet management, M&A and deleveraging from capital management & sales growth	▪ Iinvestors return to government bonds from IG as their risk/return preference for safe assets is changing in new environment ▪ Russian Invasion worsens operating environment globally ▪ M&A and shareholder enhancing activities pick up, but most are leverage neutral.
High Yield Bonds and Bank Loans	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Spreads have widened relative to 2021, creating buying opportunities for high conviction/quality and rising star trades. Expect volatility to continue. ▪ Risks for EMEA HY are heightened because of proximity to and economic impact of Russian invasion ▪ Bank loans are still attractive despite recent market softening as we expect tailwinds will pick back up: positive retail fund flows, strong issue calendar, demand from CLO formation. ▪ Defaults are set to continue near historic lows	▪ Waves of ratings upgrade continue into this year. ▪ Russian invasion significantly rattles US bond loan/market as already seen in EMEA from commodities.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ The risk/reward mix in MBS Basis approaching fair value. ▪ Specified Pools and CMOs have cheapened into market sell-off with fair fundamentals: buy opportunities. ▪ Valuations have widened since November, recently stabilizing in wider range like 2018-2019 levels. Elevated 2022 supply projections remain a headwind.	▪ Housing activity slows and rising rates move prepays to normal levels without hurting mortgage servicing rates. ▪ Uncertainty with the Fed hiking schedule and long-term position within the Fed balance sheet
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Our preference remains for Non-Agency RMBS and CLOs as spread widen and liquidity worsens ▪ RMBS: Housing continues to perform well but expect normalization coming from heavy supply and extension concerns. Selectively adding to positions at wider spreads. ▪ CMBS: Most segments maintain strong but new issue marker is slowing into spread weakness. ▪ CLOs: Spreads wider across cap structure, but sector is still reval attractive. New issue deals are slowing as investors look for discounts in the secondary market ▪ ABS: US consumer remains well positioned, although headwinds mounting. Select opportunities in de-levered structures in consumer loans or subprime auto	▪ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening ▪ Changes in consumer behavior in travel and retail fail to return. ▪ Work From Home continues full steam-ahead post-pandemic (positive for RMBS, negative for CMBS). ▪ SOFR deals slows CLO new issuance ▪ 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	▪ Global Recession

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