COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

28 MARCH 2022

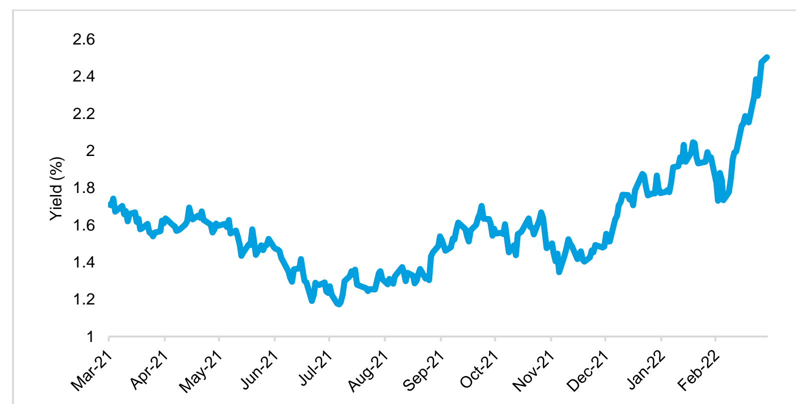
Risky 'risk-free' markets.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	2.51%	36 bps	-4.0%	-6.5%
German Bund 10 year	0.62%	25 bps	-2.9%	-5.1%
UK Gilt 10 year	1.74%	25 bps	-3.0%	-8.3%
Japan 10 year	0.25%	4 bps	-0.6%	-1.9%
Global Investment Grade	134 bps	-8 bps	-3.3%	-7.8%
Euro Investment Grade	142 bps	-6 bps	-1.7%	-5.5%
US Investment Grade	129 bps	-8 bps	-4.0%	-9.0%
UK Investment Grade	127 bps	-3 bps	-1.9%	-6.8%
Asia Investment Grade	221 bps	-16 bps	-2.7%	-5.8%
Euro High Yield	429 bps	-21 bps	-0.5%	-5.1%
US High Yield	351 bps	-30 bps	-1.9%	-5.5%
Asia High Yield	916 bps	-68 bps	-5.4%	-13.4%
EM Sovereign	391 bps	-9 bps	-2.1%	-10.2%
EM Local	6.3%	19 bps	-2.7%	-7.5%
EM Corporate	382 bps	-26 bps	-2.1%	-8.4%
Bloomberg Barclays US Munis	2.6%	31 bps	-3.2%	-6.2%
Taxable Munis	3.6%	29 bps	-6.9%	-11.0%
Bloomberg Barclays US MBS	32 bps	4 bps	-3.5%	-5.9%
Bloomberg Commodity Index	273.34	5.3%	13.4%	31.0%
EUR	1.0967	-0.6%	-2.1%	-3.4%
JPY	124.45	-2.4%	-5.8%	-5.7%
GBP	1.3148	0.0%	-1.8%	-2.6%

Source: Bloomberg, Merrill Lynch, as at 28 March 2022.

Chart of the week: US 10-year yield - LTM



Source: Bloomberg, Columbia Threadneedle Investments, as at 28 March 2022.

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Macro / government bonds

Yields headed higher last week, in a bit of a meltdown (**see chart of the week).**

The most recent sell-off has been driven by both higher real yields and rising inflation expectations. 10-year inflation expectations are the highest since the introduction of inflation-protected bonds in 1996 (at 3%); real yields have risen but are still in negative territory and also much lower than long-term averages. Rather surprisingly after only raising rates by 25bps at the last meeting, there was a raft of hawkish rhetoric from US Federal Reserve representatives last week. Meanwhile, economists around the globe are upping forecasts for interest rates in response. None of this has been easy to digest. Market pricing is now for rates to reach just under 3% within a year from now. Lastly, the weekly series of jobless claims data reached the lowest level since the late 1960s in signs of a very healthy US economy.

The UK followed other nations in reporting a historically high rate of inflation. Consumer prices rose by 6.2% y/y in February, which is a 30-year high for this particular barometer. Although core price rises (ex food and energy) rose at a lower rate of 5.2%, the CPI rate is expected to peak around 8.5% in April after the energy regulator allows for a substantial rise in bills. Consumers are facing the impact of higher fuel and heating bills, rising mortgage rates and a sharp increase in food prices. The Office of National Statistics reported that disposable income is estimated to decline by over 2% in 2022-23, the largest decline since its records began in the 1950s.

Investment grade credit

The rebound in credit spreads continues. Global investment grade spreads had widened from less than 100bps over government bonds to over 150bps in the space of two and a half months. In the last two weeks of this quarter, spreads have tightened and are now below 135bps.

A common theme has been announcements of suspension or abandonment of activity from Western companies with businesses in Russia.

High yield credit & leveraged loans

It was a more constructive week for European high yield as it was the second positive performing week, albeit a small one, as spreads tightened in more than 20bps. CCCs had another week outperforming higher-rated credit. For the first time since January, the asset class experienced inflows, across the piste, with the largest amount coming in via ETFs. The primary market re-opened with €2.9bn of deals in the form of Bayer hybrids and a cross-over rated bond from Finnish utility Teollisuuden Voima (BBB-/BB+). Although liquidity was still poor it did show signs of being relatively more balanced, albeit with longer-duration bonds still being the more challenging to trade.

In credit rating news, Paprec, the French recycling and waste management business, was upgraded by S&P from B+ to BB-, reflecting better than expected performance in 2021. In M&A news, Casino announced that it is looking to sell part or all of its 73% stake in renewable energy provider GreenYellow SAS. Valuations are around €1bn.

On the Russian front, many businesses have suspended operations in Russia since the Ukraine invasion. Noticeably, French businesses were officially told by President Macron that they could continue operations. Despite this, Renault announced last week that it is shutting/suspending operations in Russia while also announcing a significant downward revision in guidance for 2022.

The near default of Saipem, the Italian energy company, looks likely to be avoided. A large rescue package was announced at the end of last week, which included a €2bn capital raise with ENI and CDP underwriting a portion and the remaining being covered by a pre-underwriting agreement with primary Italian and international banks. A strategic plan has been approved that includes accelerated cost reductions and improving liquidity measured through a sale of onshore drilling (of which Saipem is in talks with KCA Deutag in the UK). This reinforces the low default picture in European high yield with above historical recovery rates.

Structured credit

Mortgages continued to struggle with further pressure on the sector last week. With rates continuing to rise due to higher rate hike expectations and a more hawkish tone from the US Fed, the pace of the sell-off has accelerated. The pace exceeds the post-Brexit and prior Fed balance sheet run-off periods and is now comparable to the 2013 taper tantrum. With interest rates higher and mortgage rates following suit, durations have extended while refinance activity is continuing to slow. Within credit segments of structured markets, spreads were mostly wider week-over-week, while high new issuance continues to put pressure on spreads. Fundamentals are still strong within the space with falling delinquencies; however, record new issuance in Q4, 2021 and now Q1, 2022 are weighing on structured credit markets.

Asian credit

Meituan delivered a decent set of Q4 results, with strong quarterly revenue growth and its Q4 operating loss narrowed to CNY5bn (Q3: operating loss of CNY10.1bn). This was thanks to lower q/q losses in its 'New Initiatives' business segment and an improvement in its food delivery business. On a FY basis, however, operating losses widened to CNY23.1bn (prior year positive operating loss of CNY4.3bn) due to its loss-making New Initiatives segment. Positively, the net cash position remained strong at CNY57.9bn. While the company expects the near-term trading outlook to be challenging due to the pandemic, management will focus on high-quality growth, improve unit economics and it expects the operating loss for new businesses to decline in 2022.

In the Chinese property sector, several companies have announced that they will delay the release of audited FY results and some companies have also changed their auditors. Sunac, Shimao, Powerlong and Guangzhou R&F are among the companies that will be unable to release their audited FY results by end-March 2021. Instead, they will release their unaudited FY results first by end-March 2021 and subsequently release their audited results by end-April 2021. Shimao and Powerlong also announced that PwC has resigned as their auditor.

Emerging markets

Spreads are now over 80bps wider within the sovereigns and quasi sovereigns index (EMBI) and 70bps wider for corporate index (CEMBI), in what has been the worst quarter in 24 years for emerging market debt.

In China, half of the city of Shanghai has been plunged into lockdown following surging covid cases (3,500 on Sunday). Public transport and ride hailing services will be suspended. Additionally, firms and factories will cease manufacturing or be forced to work remotely. The lockdown is intended to

last for less than a week; however, the measure is expected to hamper Q1 GDP growth, which further brings into question China's 5.5% growth target.

In contrast, South-East Asian countries have been re-opening their boarders through quarantine free travel. The move aims to tackle high unemployment caused by the downturn in tourism, which represents more than 10% of GDP for the likes of Cambodia and Thailand. Despite the move, Chinese tourists are still required to quarantine upon returning to China and Russian tourists represent a significant chunk of tourism revenue. The IMF stated Sri Lanka is facing a "clear solvency problem" because of unsustainable debt levels and has pointed towards an excessive fiscal adjustment to alleviate the burden. The IMF also highlighted the persistent balance of payment shortfalls and high FX debt service levels to pay off hard currency debts.

In central bank news, Mexico (+50bps), South Africa (+25bps) and Hungary (+100bps) all delivered interest rate hikes. The Philippines kept rates on hold at 1.5%. Elsewhere, Brazil's central bank re-iterated that the benchmark rate of 12.75% is sufficient to bring inflation expectations to target.

Commodities

Energy had another stellar week with brent (+10.8%), US natural gas (+14.5%) and gas oil (+12.3%) all delivering double digit returns. Prices were driven higher on concerns of an EU Russian energy ban, alongside another Houthi militant attack on a Saudi Aramco storage facility in the city of Jeddah.

The EU now appears to have stepped back from the potential ban as a result of the impracticality and potential disruption in the short term. Despite the bans on Russian energy from the UK, US and Australia, Russian energy is also finding a market in India and China at a discounted price. Agriculture rallied 2.8% on the week, with wheat contributing 3.8%. In Ukraine, agriculture minister Leshchenko indicated spring planting could fall by half because of the ongoing war. Leshchenko urged farms to sow more spring wheat, buckwheat, oats, millet and spring barley. In base metals Nickel resumed trading on LME and was down 4.1% on the week. Contracts are now trading at a more normalised level relative to those on the Shanghai exchange.

Responsible investments

The US Securities and Exchange Commission is looking to companies to disclose their greenhouse gas emissions, and other carbon related figures, under a new plan. In the proposal last week, using the TCFD policy as a starting point, companies in the US may soon have to disclose their plans on how they are dealing with climate change. The proposal will be finalised in 60 days after a public comment period has taken place, which may lead to revisions being made.

China may soon become the world's largest national issuer of green bonds. Despite having a somewhat alternative definition to 'Green' in comparison to other nations, they've issued more than any other country this year so far with around $21bn in total onshore green bond issuance, according to Bloomberg. This is in keeping with the upward trend over the last few years (around $13bn was issued in 2020 and approximately $60bn for 2021, according to Bloomberg).

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views
28th March 2022

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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