INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

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Another quiet week

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.27%	-3 bps	-0.3%	-1.7%
German Bund 10 year	-0.46%	-1 bps	0.1%	-0.7%
UK Gilt 10 year	0.59%	-2 bps	0.2%	-2.9%
Japan 10 year	0.02%	1 bps	-0.1%	0.3%
Global Investment Grade	93 bps	0 bps	-0.3%	-0.1%
Euro Investment Grade	85 bps	0 bps	0.0%	0.7%
US Investment Grade	93 bps	0 bps	-0.5%	-0.3%
UK Investment Grade	90 bps	1 bps	0.2%	-0.9%
Asia Investment Grade	211 bps	-4 bps	0.0%	-0.1%
Euro High Yield	313 bps	0 bps	0.3%	3.7%
US High Yield	336 bps	4 bps	-0.3%	3.7%
Asia High Yield	657 bps	-25 bps	2.1%	-1.6%
EM Sovereign	322 bps	2 bps	0.0%	-0.5%
EM Local	5.0%	4 bps	-0.7%	-4.5%
EM Corporate	311 bps	-1 bps	0.2%	1.7%
Bloomberg Barclays US Munis	0.9%	4 bps	-0.3%	1.6%
Taxable Munis	2.1%	-1 bps	-0.2%	2.3%
Bloomberg Barclays US MBS	33 bps	1 bps	-0.2%	-0.4%
Bloomberg Commodity Index	202.15	0.5%	-1.1%	22.0%
EUR	1.1772	0.3%	-0.6%	-3.4%
JPY	109.36	0.6%	0.1%	-5.7%
GBP	1.3865	0.0%	-0.3%	1.4%

Source: Bloomberg, Merrill Lynch, as at 13 August 2021

Chart of the week: US Consumer Price Inflation (y/y) 2001-21

Source: Bloomberg and Columbia Threadneedle Investments, as at 16 August 2021

Macro/government bonds

Bond markets continue to lack much direction. It was inflation week in the US. As expected, the headline rate of consumer price inflation came in at 5.4%, unchanged from the prior month (see **Chart of the week)**, while the core (ex food and energy) rate was a more modest 4.3%. The less important PPI report came in ahead of expectations with Producer Prices reaching 7.8% year-on-year. Meanwhile the US Senate agreed a bipartisan spending package of around $550 billion for the coming eight years while around half of state governors ended employment support packages in the last few days.

In the UK, GDP increased by 1% month-on-month in June, slightly exceeding the consensus though the prior months reading was revised lower. So, for Q2 as a whole the economy grew by 4.8%.

For markets the upcoming Jackson Hole symposium is the next big event when we expect to be guided by the US Central Bank as to their intentions regarding tapering of asset purchases. This week we have Retail Sales and Industrial Production data from the US.

Investment Grade credit

I feel as though we write this every week, but credit spreads were unchanged last week with the global index remaining at around the mid-90s in terms of spread. The index spreads have so far traded in a 14bps range this year. This compares to a range of 242bps last year. Regionally there is little to choose from markets which are all around 10% tighter this year.

As earnings and guidance continues to be solid, we expect to see credit fundamentals (eg net and gross leverage) continue to improve into the end of 2021 and reach around the same level as was the case at the end of 2019 (after the weakness in 2020). The market also remains supported by "technical" with Central Bank buying, and negative interest rates in Europe and Liability Management Activity in the US (eg CVS and Becton Dickenson) at a time of reduced supply compared to last year. It's worth noting last week was busy in the US Primary market though very quiet in Europe as is usual at this time of year. Valuations, or spreads, remain expensive with global spreads around 0.6 standard deviations rich to the long run average.

High Yield credit

US high yield bond prices were lower over the week amid the second consecutive week encompassing the heaviest capital market activity since mid-April. The ICE BofA US HY CP Constrained Index returned -0.14%. Spreads widened 3bps and yields were 5bps higher. Nearly $14 billion of new bonds were issued over the week, which follows the prior weeks' heaviest volume since April, totaling nearly $15 billion. The asset class reported a $510 million inflow for the week, according to Lipper.

European High Yield had a steady week with credit spreads unchanged at 313bps and a flat return as lower rated credits mildly outperformed. The asset class had another week of inflows with €116 million, largely due to managed accounts. The primary market was quiet with zero issuance, the first such week since the end of 2020. The summer lull is here.

There was, however, another rising star as Arcelor Mittal was upgraded back to IG from Ba1 positive outlook to Baa3 stable. This is another example of a 2020 fallen angel that has recovered with the improved economic picture to return to an IG rating. In other positive news, it was announced that the German government plans to sell a quarter of its holdings in Lufthansa. It has a 20% ownership due to the Covid support package made available to the airline carrier, last year. In M&A news, Faurecia SE, the French auto parts company, announced it will take over German automotive supplier Hella, valued at €6.8 billion. This acquisition will make Faurecia the world's seventh largest auto parts supplier, putting it in a better position to sell electric mobility products. This was good news for the equity side, though the bonds sold off as this will likely delay plans to move to IG rating.

Leveraged loans

The average price of the J.P. Morgan Leveraged Loan index increased $0.04. Inflows for loan funds reached a five-week high of $423 million alongside the rise in rates following inflows averaging a more modest $189 million per week over the prior four weeks.

Structured credit

The US Agency MBS market returned 5bps last week. Broadly speaking, the trend has been towards wider spreads on lower bank demand and tapering concerns. Sentiment is growing towards a taper that begins late 2021/early 2022. In the non-agency RMBS market, the fundamental tailwind continues. Home price appreciation has catapulted into the 17% range on extremely low supply. Borrower performance continues to improve with mortgage delinquency/forbearance at 3.4%. CMBS spreads steepened on the week with high quality rallying and mezzanine drifting wider. There was a bit of a supply uptick in mezz bonds while supply at the top of the stack was below average, but generally investors have become more defensive on Delta-variant concerns.

Asian credit

Geo Energy reported positive Q2 results with EBITDA that tripled y/y to $30.8 million. The quarter-on-quarter performance, however, was weaker because of higher cash cost, which is not surprising given that production cost is linked to coal prices. Despite dividend payments, the company maintained a healthy net cash position of around $23 million.

In China, the effects of the Delta variant are in focus. The Ningbo-Zhoushan port, which is the largest in China by total cargo volume and the second largest in container volume, has partly shut down one terminal at the Yangtze River Delta. The port accounts for around 25% of total port container throughput. This supply chain disruption will drive exporters to look for alternative terminals, similar to the situation in May during the shutdown of the Shenzhen Port.

The State Council in China has published a five-year blueprint that calls for the expansion of legislation in many areas, from national security, technology and public health to education and the environment. The substance of the blueprint is not entirely new, though it signals that regulatory actions would be sustained over the next five years across various sectors. In China HY properties, Evergrande continues to be in the spotlight. The central government, which is concerned about potential systemic risks, has given instructions to the Guangdong provincial government on how to manage the financial distress at Evergrande. Both the provincial government and Evergrande are directed to speed up the process of getting strategic investors to finance ongoing property projects or to sell the projects to other property companies.

Emerging markets

In China, July data for retail sales, industrial production and fixed asset investment all came in weaker than expected. Retail sales were constrained by China's strict response to the Delta variant. Industrial production was hampered by lower steel production driven by emissions reduction efforts and the partial closure of a key container port.

In Malaysia, Prime Minister Yassin has resigned. This follows his party losing a majority in parliament as a consequence of an inadequate response to Covid-19. The Malaysian central bank recently halved its 2021 GDP projection to 3%-4%.

In Central Bank news, Mexico and Peru hiked rates 25bps to 4.5% and 0.5% respectively.

Commodities

Iron ore continues its slide, falling 6.8%, and is now 30% of its 2021 peak. The decline has been driven by reduced Chinese steel production. Grains had a strong week, rallying 3.3% following the most recent USDA report. The report indicated large reductions in crop sizes of key global wheat producers. In the softs market, both coffee (3.8%) and sugar (6.8%) gained due to the Brazilian frosts. In response to climate threats Brazilian coffee producers are now turning to Robusta beans (from Arabica), which are more heat resistant.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

16th August 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. ■ Credit fundamentals across sectors are improving. In fact, some areas see such strong demand turnaround that supply constraints are throttling further growth. ■ Spreads are near all-time tights and leave little room for the growth story to get derailed, but 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.	■ 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: 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, and financial conditions for EMs is tightening.	■ 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. ■ Balance sheets weathered 2020 well, and are deleveraging due to responsibly capital management and good sales growth. ■ IG has been historically resilient in the face of inflation, even if other sectors may benefit more from it.	■ 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	■ Although spreads have recently widened a touch, the Fed buying has overwhelmed highly negative fundamentals, evidenced by the near-zero spreads in bonds the Fed buys and poor performance elsewhere. ■ These unattractive technicals may persist if the Fed continues buying. Fed buying cannot be expected to increase in 2021, ultimately exposing negative fundamentals and valuations. ■ Duration in the sector is now rising quickly as mortgage rates move higher.	■ 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.
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: favoured bonds are still 'story' bonds. A return to normal won't look 'normal' for sectors like office space or convention hotels ■ 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 ■ o/w Grains ■ u/w Livestock ■ u/w Gold ■ u/w Natural Gas	■ US China trade war ■ Renewed Covid lockdowns

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 06.07.2020, unless otherwise stated.