COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

19 JULY 2021

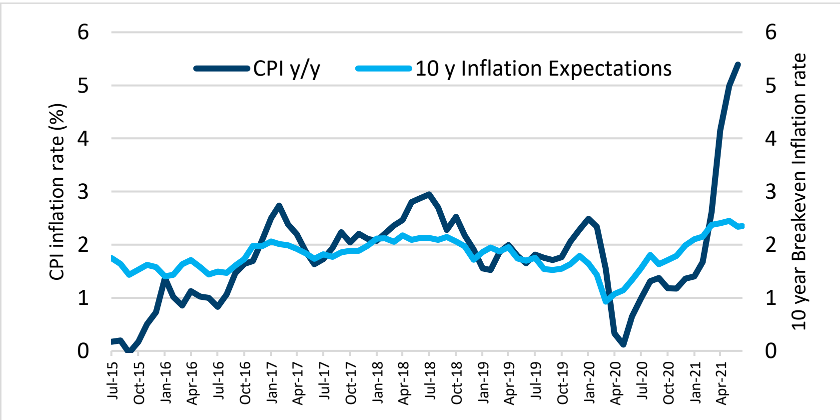
The arrival of long expected inflation.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.24%	-12 bps	0.9%	-1.8%
German Bund 10 year	-0.38%	-9 bps	1.1%	-1.7%
UK Gilt 10 year	0.59%	-6 bps	1.4%	-4.5%
Japan 10 year	0.02%	-2 bps	0.5%	0.3%
Global Investment Grade	92 bps	1 bps	0.7%	-0.3%
Euro Investment Grade	83 bps	-1 bps	0.6%	0.2%
US Investment Grade	91 bps	1 bps	0.7%	-0.3%
UK Investment Grade	91 bps	1 bps	0.8%	-1.7%
Asia Investment Grade	209 bps	-2 bps	0.4%	-0.2%
Euro High Yield	312 bps	0 bps	0.2%	3.2%
US High Yield	318 bps	11 bps	0.2%	3.9%
Asia High Yield	591 bps	-15 bps	0.4%	0.9%
EM Sovereign	322 bps	2 bps	0.5%	-0.5%
EM Local	5.0%	-2 bps	-0.7%	-4.0%
EM Corporate	306 bps	2 bps	0.4%	1.7%
Bloomberg Barclays US Munis	0.9%	0 bps	0.7%	1.8%
Taxable Munis	2.1%	-4 bps	1.5%	1.9%
Bloomberg Barclays US MBS	34 bps	2 bps	0.3%	-0.5%
Bloomberg Commodity Index	200.12	1.0%	-0.1%	21.0%
EUR	1.1777	-0.6%	-0.4%	-3.4%
JPY	109.78	0.0%	0.9%	-6.1%
GBP	1.3712	-1.0%	-0.5%	0.7%

Source: Bloomberg, Merrill Lynch, as at 17 July 2021.

Chart of the week: Actual and expected US Inflation, 2015-21



Source: Bloomberg, Columbia Threadneedle Investments, as at 15 July 2021.

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Macro / government bonds

Inflation had long been expected to rise – and rise it has! Data released from the US and UK last week showed a jump in prices that exceeded (increased) expectations by some margin. Starting in the US, Consumer and Producer Price data rose to 5.4% and 7.3% y/y respectively with a leap in core (ex food and energy) inflation. The **chart of the week** shows that actual inflation is now well above expected future inflation. In other words, the market believes that inflation will be higher than was the case (in 2020) but not as high as these recent prints suggest in the longer term. Why so? Factors pushing prices higher seem likely to be short lived and include the reopening in the economy, a comparison to very low levels last year and supply shortages such as used cars (up an astonishing 10% on the month). UK CPI inflation also rose and to a three-year high of 2.5%. Energy prices have added to inflation concerns with the oil price around 50% higher year-to-date.

The bond market seems to believe this trend is temporary asgreeing as it were trumpeted by policy makers at the US Federal Reserve. Indeed as can be seen, inflation expectations that had risen from 0.5% in early 2020 to 2.6% in the late spring of this year have actually gradually drifted lower to around 2.35% today.

If the rise in inflation does indeed prove to be short lived then we can have confidence that the Fed will not need to rush to taper asset prices or raise policy rates. If the rise is something more permanent, and helps push wages higher it will be a more difficult period for bond markets.

Investment grade credit

Investment grade spreads have not shared the volality in inflation and bond yields. Spreads still remain locked in a very tight trading range; as mentioned last week.

US Bank results last week were decent enough. Return on Equity nearly doubled from last year (a low comparison point admittedly) as institutions saw write-backs and exhibit strong asset quality. Capital ratios remain high but payouts to equity holders have increased. Markets businesses declined, however, led by a fall in fixed income though equities fared batter. Meanwhile, there were some signs of greenshoots of a recovery in demand from the US consumer for credit.

Globally the banks index has lagged the broader market and while Global IG spreads are nearly 12% tighter this year Banking is closer to 8% tighter. Last week these results were met with heafty supply from the major US banks.

High yield credit

Despite the strong start to second quarter earnings, US high yield bond prices were modestly lower over the week amidst volatility in rates, higher than expected inflation data and increased concerns surrounding the spread of the Covid-19 delta variant. The ICE BofA US HY CP Constrained Index returned -0.17% over the week. Spreads widened 11bps to +327bps while yields increased to 3.88%. After three consecutive weekly inflows, outflows returned with $1.4bn withdrawn from retail funds, primarily via ETFs.

European high yield had another stable week as credit spreads remained unchanged at 312bps with BBs outperforming CCC (latter negatively performed on the week). Inflows slowed down a little, with only €74m coming into the asset class but evenly split between ETFs and managed accounts.

It was a heavy primary week with €3.4bn in new corporate issuance, including another sustainability linked bond by PPC, the Greek utility company and new issuers Sani Ikos (Greek resorts) and Apcoa Parking.

The improving credit picture continued with a rating upgrade for EnQuest, the British petroleum company, as S&P moved the rating from CCC to B-. Pizza Express was also upgraded to CCC+ from CCC- as liquidity improved due to the company's initiatives and the Yum! Alliance agreement renegotiation. Moody's upgraded Gestamp to Ba3 (from B1) bringing the issuer to Ba3/ BB. Finally, FCE Bank (Ford) was upgraded to investment grade by Moody's, which means it will leave the European high yield universe at the end of this month. M&A stories also abound with Pure Gym reiterating its intention to IPO while UniCredit headlines increased the likelihood of Monte de Paschi takeover. United Group announced that it is in the process of buying fixed line operator Optima in Croatia as PPF Telecom shared news of an agreement to sell its Montenegro operations to 4iG.

In sector news, the European Commission announced the "Fit for 55" programme, which is likely to strongly impact the auto sector. Its climate change programme includes 13 measures aimed at a 55% reduction in carbon emissions by 2030 (increased from an original plan of 37.5%) and a total ban of all combustion engine car sales from 2035 onwards as part of the EU's C02 emission target for 2035. Newly registered cars will have to have reduced emissions by 55% by 2030 and by 100% by 2035 compared to 2021.

Leveraged loans

Leveraged loan prices held steady over the week at $98.6. Within the J.P. Morgan Leveraged Loan Index, BB prices increased $0.02 to $99.42, Single Bs increased $0.01 to $99.40, and Split B/CCCs decreased $0.16 to $91.24. Loan yields (3-year) increased 2bps w/w to 4.72%, while spreads (3-year) decreased 2bps to 421bps. The asset class experienced its 27th consecutive retail fund inflow with a $394m contribution over the week. That said, the inflow was well below the year-to-date weekly average of $790m.

Structured credit

The US Agency MBS market posted an 11bps total return last week as interest rates rallied. The story continues to be the robust US housing market with prices climbing at their fastest pace ever. The Case-Shiller national index came in at +14.6%, which surpassed its prior peak set in September 2005. Historically tight supply with inventory down by more than 20% y/y and low interest rates are pushing prices higher. Borrower performance is strong. The share of borrowers in forbearance fell below 4%. That number breaks down to about 2.3% of agency RMBS and 4.4% of non-agency RMBS. Moving forward, as fiscal support wanes and the foreclosure moratorium lifts, higher home equity values, alongside an improving economy, should incentivize borrowers to reperform. In ABS, new issuance volumes are hitting new highs not seen since Q2, 2006. At $163bn, issuance volumes are up 70% in the first half of 2021 vs. 2020. Elevated supply continues to be met with sufficient demand with spreads relatively range bound. Strong consumer balance sheets, an improving jobs market and wage growth have all combined to keep delinquency rates low. Loan modifications are a fraction of where they were at the onset of the pandemic and those remaining are long-term in nature. While delinquencies are falling, prepayment rates continue to climb higher and the CMBS market continues to improve as the US economy reopens. Delinquency/forbearance sits at around 6% of the overall market with an ongoing distinction across specific segments of the market most impacted by Covid-19.

Asian credit

PTT Global Chemical (PTTGC) announced the acquisition of Allnex Holding GmbH for an EV of €4bn (c.$4.75bn), which includes the target's debt of €426m. Allnex is a Germany-based producer of industrial coating resins and additives for architectural, industrial, protective, automotive and special purpose coatings. PTTGC plans to use a combination of cash, proceeds from its divestment of Global Power Synergy, the PTT credit facilities (THB32bn) and its operating cash flow to fund the transaction. Additional financing flexibility will come from a shareholder loan of around $2.27bn from PTT PCL (parent company which owns 45.4% of PTTGC) and debt financing of THB15bn.

In China, the State Administration for Market Regulations (SAMR) has approved Tencent's acquisition of the 61% stake in Sogou (search engine platform) that it does not currently own for around $2.1bn. On another hand, SAMR ordered Tencent to terminate the merger of the game-streaming platforms and Huya Inc and Douyu International Holdings. Both these companies hold more than 70% of China's game-streaming market by revenue. Tencent owns a 36.% stake in Huya and more than 33% stake in Douyu.

Emerging markets

Covid-19 once again dominated the headlines in emerging markets with Indonesia recording 51,952 new cases on Saturday, surpassing both Brazilian and Indian cases counts. Daily cases were surpassed by only the UK, but Indonesian testing capacity is far lower. Thailand has reported its highest single day increase in infections at 11,784 and will now use more Chinese made Sinovac vaccines, which were previously administered to people following an initial AstraZeneca shot.

Last week South Africa was gripped by protests following the sentencing of former South African president Jacob Zuma. Both corruption and inequality drove the demonstrations, the latter of which has only been exacerbated by Covid restrictions. Thailand is also protesting in response to the perceived mismanagement of the government's Covid response. The protesters are demanding mRNA vaccine supply (Moderna or Pfizer) and enhanced government Covid support.

In China export data surprised to the upside as the y/y increase for June came in at 32.2%, up from 27.9% for May. However, this was offset by industrial output slowing from 8.8% to 8.3% y/y. Fixed asset investment also softened to 12.6% for H1 2021, down from the 15.4% increase from January to May.

Commodities

Brent declined by 2.2% following the resolution of the Saudi Arabia UAE production dispute. As a result, supply will now be hiked by 400,000 barrels a day. The UAE had its production baseline increased from 3.17 to 3.50 million barrels per day. Rising delta variant cases globally have also levied downward pressure on prices.

Agriculture had a strong week rallying 5.6% on aggregate. Wheat rallied 12.6% following floods in Germany and Northern Europe. Corn rose 5.0% on the back of dry and hot weather forecasts for the US corn belt.

Responsible investments

Due to stricter policies in recent years, assets in the European sustainable investment market (green, social and sustainability bonds etc.) lost $2trn between 2018 and 2020, according to a report from the Global Sustainable Investment Alliance. The parameters for considering issuance to be classed a responsible investment have been tightened over the last few years as a result of the introduction of anti-greenwashing rules (a.k.a. SFDR). Contrary to this, the same report showed the US sustainable investment market gained $5trn over the same time period, and Canada topping the list for largest proportional gain of ESG assets with a 42% increase to $2.4trn.

Key players in the renewable energy industry have written a letter to nations leaders of the G20 to take immediate action on ramping up the use of green power to prevent further global warming. The head of the Global Wind Energy Council along with CEO's from Orsted A/S and turbine manufacturer Vestas Wind Systems A/S, have requested the G20 council to up current renewable targets as well as agree on effective carbon pricing. The G20 energy and environment officials are due to meet in Italy this week.

On Friday, the Bank of Japan surprisingly announced that it would be financially supporting banks that lend to climate-friendly companies. It's hoped this move will help move the country improve towards it's net-zero goal by 2050.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

19th July 2021

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	▪ Growth is robust as we emerge from the worst of the COVID experience, nowhere more than in the US. Credit fundamentals across sectors are improving rapidly. In fact, the demand turnaround is so severe in some areas 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	▪ The Fed buying has overwhelmed highly negative fundamentals, as seen 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

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