INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

5 JULY 2021

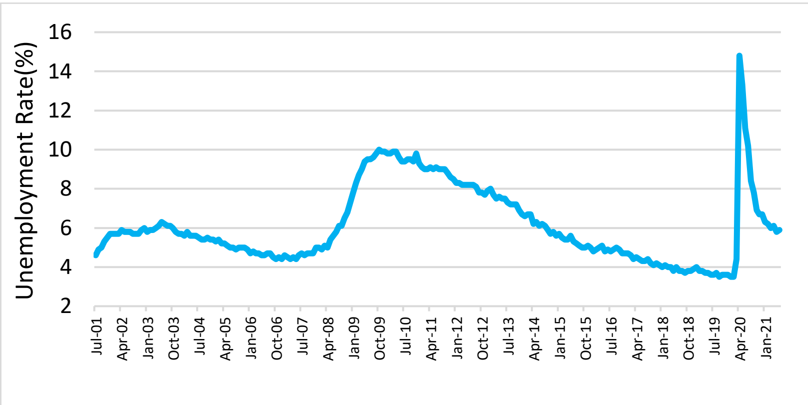
A game of two quarters.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.42%	-10 bps	0.1%	-2.6%
German Bund 10 year	-0.22%	-7 bps	0.2%	-2.6%
UK Gilt 10 year	0.72%	-6 bps	0.2%	-5.7%
Japan 10 year	0.04%	-1 bps	0.2%	0.0%
Global Investment Grade	90 bps	1 bps	0.1%	-0.8%
Euro Investment Grade	84 bps	1 bps	0.1%	-0.3%
US Investment Grade	87 bps	1 bps	0.1%	-1.0%
UK Investment Grade	90 bps	0 bps	0.1%	-2.3%
Asia Investment Grade	203 bps	2 bps	0.0%	-0.6%
Euro High Yield	310 bps	9 bps	0.0%	3.0%
US High Yield	304 bps	0 bps	0.2%	3.9%
Asia High Yield	586 bps	11 bps	0.0%	0.5%
EM Sovereign	316 bps	10 bps	0.0%	-1.0%
EM Local	5.0%	-4 bps	-0.4%	-3.7%
EM Corporate	298 bps	10 bps	0.1%	1.4%
Bloomberg Barclays US Munis	1.0%	-2 bps	0.1%	1.1%
Taxable Munis	2.2%	-8 bps	0.2%	0.6%
Bloomberg Barclays US MBS	28 bps	3 bps	0.1%	-0.7%
Bloomberg Commodity Index	202.79	2.7%	0.5%	21.7%
EUR	1.1878	-0.6%	0.1%	-2.9%
JPY	110.81	-0.2%	0.1%	-6.9%
GBP	1.3856	-0.4%	-0.1%	1.1%

Source: Bloomberg, Merrill Lynch, as at 2 July 2021.

Chart of the week: US Unemployment Rate, 2001-2021



Source: Bloomberg, Columbia Threadneedle Investments, as at 5 July 2021.

David Oliphant
Executive Director,
Fixed Income

Contributors

David Oliphant
Macro / Government bonds, Investment Grade Credit

Angelina Chueh
Euro High Yield Credit

Chris Jorel
US High Yield Credit, US Leveraged Loans

Katherine Nuss
US Investment Grade Credit

Kris Moreton
Structured Credit

Justin Ong
Asian Fixed Income

Doug Rangel
Municipals

Charlotte Edwards
Responsible Investments

Jake Lunness
Commodities
Emerging Markets

Macro / government bonds

Welcome to the second half of 2021.

From a macro / government bond perspective, a weak first quarter of the year was all about rising inflation expectations in the US in the wake of President Biden's grand plan, the successful rollout of vaccines, the reopening of economies and upgraded growth forecasts. This led to higher yields, steeper yield curves and negative returns. The last three months has been more balanced and better for rates markets. Though inflation has actually risen materially, this had been widely expected and discounted, so bond prices have been improving. Yield curves have also re-flattened somewhat as the US Federal Reserve sought to impress with a more hawkish outlook to contain inflation risks.

It is hard to say we start July with attractive yields but the levels of inflation 'priced-in' seem sufficient if inflation does indeed prove to be indeed transitory. Real yields, however, remain low. As mentioned last week, business and consumer sentiment readings continue to be strong. In the US, the Conference Board's sentiment index reached another post-pandemic high though the ISM Manufacturing survey weakened a little. In Europe, the European Commission's Economic Sentiment Indicator achieved a level not seen in over 20 years. The week ended with the US employment report; June payrolls rose by 850k, above the consensus of 720K. The unemployment rate rose by 0.1% to 5.9%, above the consensus **(see chart of the week**). Average hourly earnings rose 0.3%, in line with consensus to 3.7% y/y.

UK house prices rose by a record 13% y/y in June data released by Nationwide. This reflects very low borrowing costs and a temporary tax break. Less good news was the ongoing increase in Covid-19 cases in the country, though a substantial proportion of the adult population is vaccinated.

Investment grade credit

Like their government bond cousins, the second quarter of this year proved less eventful than the first for credit spreads.

Spreads had tightened meanginfully between December 2020 and March of this year. Since then, credit spread volatility has been very low though index spreads were tighter again by the end of June. Geographically, the US dollar market has led the way this year with spreads around 17% tighter. Euro and sterling credit came in at 11% and 9% tighter respectively. Investment grade lagged high yield, however, where spreads were tighter still on a 'risk-adjusted' basis.

What of the outlook for investment grade credit? We feel credit markets will remain supported by accomadative present and implied future policy conditions, improved economic prospects and an improvement in credit quality; that should see key metrics return to a similar level later this year as at the end of 2019. Meanwhile, demand for income (with some degree of safety) remains a powerful positive force at a time of reduced (relative to last year) supply. Balancing these factors are spreads which seem fully valued if not tight. The Global index spread at 90bps is around 1.2 standard deviations rich to the five year average and 0.7 sds expensive to a longer term 20-year comparison.

High yield credit

The European high yield market softened with spreads widening 9bps on the week and ending at 308bps for the month of June.

The primary market finally showed signs of slowing down, with only five new issues last week, but two of these were 'jumbo' size (Softbank's €2.95bn and Picard's sustainability linked €1.7bn). This was almost €6bn in total and puts June 2021 as a historical high month with €20.9bn in new issues.

There were more signs of an improving economic picture, this time from the building supplies and construction sector with guidance and/or outlook upgraded at Rexel, Travis Perkins, and PCF due to strong order books and the ability to pass through higher raw material prices.

In stock specific news, there was encouraging news for Grifols, which is in the blood plasma business, as the Singapore Sovereign Wealth fund announced it is investing $1bn into the firm. It will have a minority stake in the entity that manages the plasma collection centres in the US (almost 300 centres), while Grifols will maintain control over the centres. Money will be used to reduce leverage and further expand the collection network. Overall this is positive news, as it is in line with Grifols' long-term plans to expand the network and increase the collection amount to meet the growing demand.

Asian credit

Fitch maintains the rating watch negative outlook on SF Holding Co Ltd's A- rating given the lack of clarity over the company's financial position prior to completing the acquisition of a 51.8% stake in Kerry Logistics Network Limited for around HK dollar 17.6bn. SF Holding plans to raise up to CNY20bn through an A-share placement, which can more than cover the cost of the acquisition. However, Fitch is also assessing the sustainability of the company's cash flow generation and leverage. For India, Fitch has downgraded Delhi Airport to BB- with a negative outlook to reflect the weak traffic performance from the second coronavirus wave and a longer period for traffic recovery to pre-pandemic levels by end-2024, compared with Fitch's earlier expectation of end-2023.

Moody's has affirmed Indonesia Asahan Aluminium (Inalum)'s Baa2 rating and lifted the ratings outlook from negative to stable. Inalum's subsidiaries notably PT Timah and PT Aneka Ambang are expected to sustain their strong performance over the next 2-3 years. Furthermore, Inalum expects to receive an initial dividend from PT Freeport Indonesia (PTFI) in 2021, which will rise significantly from 2023. PTFI will displace Bukit Asam as the largest dividend contributor to Inalum from 2023.

The June gross gaming revenue (GGR) in Macau fell by 37% m/m due to the tighter border controls between Macau and Mainland China that were implemented in early June. Around 60% of visitors come from Mainland China. However, the Q2 GGR was the highest since the start of the pandemic thanks to the strong GGR in May. Positively, Hong Kong and Macau are reportedly planning a limited reopening of travel between the two cities by mid-July with travellers being exempted from quarantine. Travellers from HK account for around 20% of the inbound traffic to Macau.

Emerging markets

In China, the state regulator has been cracking down on US listed Chinese technology firms. Three companies: Didi Global Inc, Full Truck Alliance and Kanzhun Ltd have all been forced to cease new user registrations and app stores have been made to remove their apps. The communist party is supposedly cracking down due to concerns regarding individual privacy and national security.
On the macro front, China's Caixin services PMI for June came in at 50.3, the second consecutive decline, as services have been hampered by rising Covid cases within China. In India the manufacturing PMI fell to 48.1; the measure was consistently trending above 55 prior to the spike in delta variant Covid cases.

In issuance news Qatar Petroleum raised $12.5bn in dollar denominated debt across five,10,15 and 20-year maturities. The issue marks the largest corporate issuance in the MENA region. The bonds will be used to finance expansion over the upcoming years.

In central bank news, Angola hiked rates from 15.5% to 20%. Columbia and the Dominican Republic both held rates at 1.75% and 3.0% respectively.
In Turkey inflation rose faster than market estimates to hit 17.5% in June, this is up from the 16.6% figure for May. Food inflation in particular rose 20%. President Erdogan previously signalled a rate cut for Q3, however, this now seems less likely.

Commodities

In Agriculture, the USDA released its crop report. Existing stocks were lower than expected and the view on acreage for corns and beans was significantly lower than market expectations. The result was a sharp supply driven rally for corn (+11.6%) and soybeans (10.2%); corn's 2021 rally now amounts to 37.2%.

In Energy, Brent finished the week just above $76 following OPEC+ talks. The UAE recently halted a deal that would have added 2 million bpd to the market but would extend production cuts beyond April 2022. OPEC+ cut production by 10 million bpd last year; discussions continue into this week.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

5th 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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