COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

11 OCTOBER 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

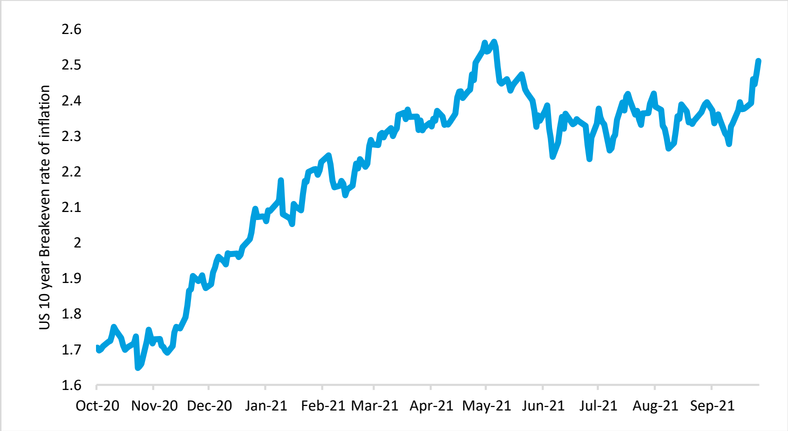
Quantum of shortage.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.61%	15 bps	-0.4%	-3.1%
German Bund 10 year	-0.13%	9 bps	-0.3%	-3.2%
UK Gilt 10 year	1.21%	21 bps	-1.5%	-9.0%
Japan 10 year	0.09%	3 bps	-0.1%	-0.2%
Global Investment Grade	92 bps	1 bps	-0.5%	-1.5%
Euro Investment Grade	86 bps	1 bps	-0.2%	-0.6%
US Investment Grade	90 bps	1 bps	-0.6%	-1.7%
UK Investment Grade	89 bps	1 bps	-1.1%	-4.4%
Asia Investment Grade	201 bps	3 bps	-0.4%	-0.4%
Euro High Yield	331 bps	11 bps	-0.5%	3.2%
US High Yield	320 bps	0 bps	-0.3%	4.3%
Asia High Yield	827 bps	123 bps	-5.3%	-11.3%
EM Sovereign	326 bps	-3 bps	-0.6%	-2.1%
EM Local	5.4%	12 bps	-0.5%	-6.8%
EM Corporate	304 bps	-1 bps	-0.5%	1.1%
Bloomberg Barclays US Munis	1.2%	3 bps	-0.2%	0.6%
Taxable Munis	2.3%	11 bps	-0.8%	0.0%
Bloomberg Barclays US MBS	25 bps	-1 bps	-0.3%	-0.9%
Bloomberg Commodity Index	221.82	1.7%	1.8%	31.5%
EUR	1.1575	-0.2%	-0.1%	-5.3%
JPY	112.79	-1.0%	-0.9%	-7.9%
GBP	1.3648	0.5%	1.0%	-0.4%

Source: Bloomberg, Merrill Lynch, as at 11 October 2021.

Chart of the week: US 10-year inflation expectations – LTM



Source: Bloomberg, Columbia Threadneedle Investments, as at 11 October 2021.

Macro / government bonds

The question of whether the present elevated levels of inflation prove to be a short-lived phenomenon is the focus for bond markets. Central bankers will have us believe that these rates reflect temporary factors such as the reopening of the economy, surging energy/commodity prices and supply chain disruptions (eg, microchips for automakers). For those of us living in the UK, this has been augmented by a shortage of truck drivers (leading to fuel and other goods shortages) and barriers to trade and labour mobility. Wages have risen too, and this rests uncomfortably with low bond yields and has led to a degree of indigestion and rising yields these last few weeks. The 10-year US government bond is now at the highest yield level since early summer and 10-year inflation expectations (2.5%) are close to the peak they reached in mid-May (2.55%): **see chart of the week**.

We had to wait until the end of the week for the US jobs report, normally one of the most important data releases in any month. Anything other than a complete miss was meant to mean that asset tapering was assured at the November FOMC. Guess what happened? We were delivered the weakest job growth number this year; well below expectations and thus complicating the US Fed's decision. September Non-Farm Payrolls rose by 194,000, falling short of the consensus expectation of 500,000. Revisions higher to prior months were strongly positive (+169,000), so a net 371,000. Weaker then, but not as weak as at it first appeared. In better news, the unemployment rate fell to 4.8% from 5.2% and well below expectations of 5.1%. Wages also exceeded expectations and rose 0.6% to around 5.5% y/y. Time to taper indeed!

Investment grade credit

Investment grade credit spreads continue to nudge one basis point up and down without much direction. The recent range of global spreads (88bps and 95bps) has been in place since the end of April this year. In the last couple of weeks, however, more 'risky' sectors such as contingent capital bonds have struggled a little, with spreads widening over 30bps since mid-September, which is a more than 10% widening. This price action is consistent with a decompression of spreads amid concern about the growth outlook.

As we head into reporting season this week (JP Morgan, Blackrock and Delta Airlines on Wednesday), we can expect an earnings-related lull in bond issuance, which creates a more positive technical backdrop to markets after the post summer/pre-earnings deluge of primary market activity that occurred in September. With regard to earnings, we shall be looking at the effect of rising costs (goods and labour) and whether companies are able to pass these on.
We seem to be observing a degree more equity friendly / bond negative M&A type activity and resulting market speculation. One of the most publicised examples of this is UK supermarket chain Morrison's, which has been taken over by a private equity firm and will very likely become a high yield issuer within the next few weeks. This has inevitably prompted some speculation about who will be next?

High yield credit

US high yield bond prices were lower over the week amidst swings in equities, rates and commodity prices. The ICE BofA US HY CP Constrained index returned -0.31% while spreads were unchanged. The yield-to-worst of the index increased 0.12% to 4.15%. According to Lipper, the asset class experienced a small retail outflow of $294m following inflows over five of the previous six weeks.

European high yield posted a third negative week in a row, with single Bs as the worst performer and CCC outperforming both BB and single Bs. This has pushed European high yields spreads wider than US high yield spreads, first time since April 2019. This was in face of doubts on the macro-outlook given inflation and growth concerns as well as likely due to the heavy volume of single B issuance. It was a busy primary market with €6.3bn equivalent in eight sterling and euro deals. These were single Bs with a dusting of CCCs. The asset class experienced an outflow of €182m, both via ETFs and managed accounts, an increase from the previous week.

Alder Group, the German real estate group, dominated news this week given renewed allegations of questionable practices and weak corporate governance by Viceroy Research, who are short sellers of the issuer. While strongly denying any wrong-doing, Adler has also announced plans to sell residential and commercial units at a value of €1.5bn (reporting sales are above book value) with proceeds to support deleveraging. Additionally, Vonovia, Europe's largest residential landlord, announced they have acquired a call option, at above market price, for 13% of Adler Group's shares.

Leveraged loans

Unlike bonds, US leveraged loan prices rose modestly over the week despite the aforementioned volatility elsewhere. The J.P. Morgan Leveraged Loan index returned 0.10% and the retail loan funds posted their 38th inflow in 39 weeks and the largest in three weeks ($561m).

Structured credit

The US Agency MBS market was down 43bps as rates bear steepened with the 10-year treasury hitting 1.60. Conventional mortgages were roughly unchanged on a spread basis, while prepay speeds for September were essentially flat. On a gross issuance basis conventionals were a bit lower at $277bn in September while CMO issuance came in about $6bn higher. September saw an uptick in UMBS 3s as collateral, growing to $6.2bn vs. $1.2bn in August. Affordability pressures are a continued theme with HPA at 19.7% year-on-year. A tight supply environment and no sign of easing credit standards are both supportive of continued home price growth, albeit likely at a slower pace moving forward.

Asian credit

Moody's has lifted the sovereign ratings outlook of India from negative to stable. The Baa3 sovereign rating is unchanged. Moody's highlighted the improvement in the solvency of the Indian financial system, better credit conditions and lower downside risks to growth from subsequent Covid-19 infections, thanks to higher vaccination rates. Following the stabilisation of the sovereign ratings outlook, Moody's has also revised its negative outlook on a number of Indian banks, quasi-sovereign companies and infrastructure companies to stable.

All three rating agencies have downgraded Fantasia Holdings Group to default or near-default status after the non-payment of its $208m bond, which matured on 5 October 2021. The company is also under further scrutiny due to an opaque transaction in which Fantasia reportedly made a partial payment to bondholders of a $100m private bond that matured on 28 September.

Emerging markets

Gold mining companies Polyus (Russia) and Endeavour Mining (West Africa) both came to market with US dollar offerings of $700m and $500m respectively. Gold prices are down 8% year-to-date.

In central bank news, Poland and Romania hiked rates by 40bps and 25bps respectively. Poland raised rates for the first time since 2012 as both nations grapple with higher energy prices. Peru also hiked rates for the third consecutive month at 50bps to 1.5%. The country is seeing the highest inflation in 12 years because of pent-up demand, following the lifting of covid restrictions.

In responsible investment news, the UAE became the first MENA country to announce a net zero 2050 target. The plan will involve $163bn of investment in renewable energy.

Commodities

The energy crisis continues to grip the headlines. Gas prices rallied significantly but later sold off (-0.6% on the week) following comments from Vladimir Putin that Gazprom could substantially ramp up supplies to meet demand. Russia has criticised Europe from moving away from long-term supply contracts.

WTI rallied 4.5% on the week and is trading above $80 as of Monday morning. The high prices in gas and coal are driving a switch back towards oil. Saudi Aramco estimate demand is up 500,000 barrels a day.

Industrial metals had a stellar week with nickel rallying 7%. Production has been halted following the power shortages in China and higher electricity prices in Europe. Higher energy prices in Europe are making nickel production unattractive. Aluminium prices rose 3.8%, to the highest level since 2008. Aluminium prices are seen as a proxy for electricity prices as electricity represents around 40% of the cost of producing aluminium.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

11th October 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. ▪ Although credit spreads have widened slightly, they are still near all time tights and leave little room for the growth story to get derailed. 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. ▪ Uncertainty is rising as Delta threatens the recovery, monetary & direct fiscal support wane, and unemployment benefits expire.	▪ 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 Delta variant cases worsen and restrictions return, threatening returns to schools, offices and travel 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 £ €	▪ Yields have broken out of their earlier tight ranges but likely to remain capped by structural downtrend in real yields and growth ▪ 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	▪ Inflation becomes more persistently entrenched, warranting much higher rate structure ▪ 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$ $	▪ The US leads the way on the economic recovery from the pandemic, which drives a monetary wedge between the Federal Reserve and ECB ▪ Window for dollar underperformance has narrowed as central banks globally turn more hawkish on inflation expectations at the expense of growth	▪ Re-acceleration of global growth forecasts led by reversal of China credit contraction ▪ 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, with the exception of countries aggressively hiking rates (like Russia and Brazil).	▪ 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. ▪ IG has been historically resilient in the face of inflation, even if other sectors may benefit more from it. ▪ Good fundamentals after most recent earnings, with strong balance sheet management and deleveraging from capital management & sales growth	▪ 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 has been the 1000lb gorilla in this market since COVID hit, and it is progressively getting closer to tapering. The Fed will taper MBS alongside USTs, but tapering will still be a headwind to the market. Banks, the other major buyers, have slowed their purchases as well. ▪ With interest rates falling again, fundamentals worsen as prepayment speed will remain elevated. Changes to FHFA housing policies could also be marginally negative for fundamentals over time.	▪ 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. ▪ 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: favored bonds are still 'story' bonds. A return to normal won't look 'normal' for sectors like office space or convention hotels and recently has lagged. ▪ 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 ▪ u/w Livestock ▪ u/w Gold ▪ o/w Soybeans ▪ o/w Oil	▪ US China trade war ▪ Renewed Covid lockdowns ▪ Global Recession

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