COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

31 JANUARY 2022

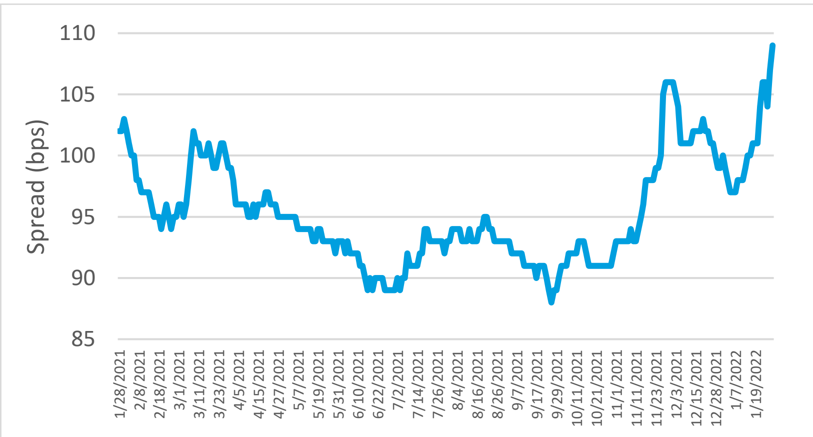
Everything weaker than everything else.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	1.78%	2 bps	-1.8%	-1.8%
German Bund 10 year	-0.03%	4 bps	-0.7%	-0.7%
UK Gilt 10 year	1.24%	7 bps	-3.1%	-3.1%
Japan 10 year	0.18%	4 bps	-0.6%	-0.6%
Global Investment Grade	109 bps	5 bps	-2.4%	-2.4%
Euro Investment Grade	106 bps	5 bps	-1.0%	-1.0%
US Investment Grade	109 bps	6 bps	-3.1%	-3.1%
UK Investment Grade	104 bps	6 bps	-2.4%	-2.4%
Asia Investment Grade	188 bps	1 bps	-1.7%	-1.7%
Euro High Yield	371 bps	23 bps	-1.3%	-1.3%
US High Yield	361 bps	32 bps	-2.9%	-2.9%
Asia High Yield	723 bps	3 bps	-3.8%	-3.8%
EM Sovereign	349 bps	3 bps	-2.9%	-2.9%
EM Local	5.9%	7 bps	-0.9%	-0.9%
EM Corporate	319 bps	4 bps	-1.7%	-1.7%
Bloomberg Barclays US Munis	1.7%	29 bps	-2.7%	-2.7%
Taxable Munis	2.7%	11 bps	-3.0%	-3.0%
Bloomberg Barclays US MBS	19 bps	-6 bps	-1.5%	-1.5%
Bloomberg Commodity Index	231.69	1.7%	8.1%	8.1%
EUR	1.1171	-1.7%	-1.9%	-1.9%
JPY	115.43	-1.4%	-0.1%	-0.1%
GBP	1.3435	-1.1%	-1.0%	-1.0%

Source: Bloomberg, Merrill Lynch, as at 31 January 2022.

Chart of the week: Global investment spreads – LTM



Source: Bloomberg, Columbia Threadneedle Investments, as at 31 January 2022.

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It has not been a good month for financial assets.

Core bond yields and interest rate expectations rose, the US Federal Reserve maintained a hawkish tone, geopolitical tensions simmered in a stand-off between Russia and NATO, credit spreads widened, equities indices tumbled, while the only real beneficiaries were the US dollar and higher energy prices. This has left most bond market indices in negative total return territory for the year so far.

In terms of market background, we saw US Q4, 2021 GDP come in well ahead of expectations at 6.8% q/q annualised, though this was inflated by an inventory increase. This will probably reverse with Q1, 2022 data. Elsewhere, US business and consumer sentiment both dipped into the year end and weekly jobless claims rose as the Omicron variant took its toll, although the unemployment rate broke below 4% in December. Inflation also came in at a remarkably high 7% y/y and has proved to be less transitory than was expected a few months ago.

Growth collapsed in Germany in Q4, 2021 where GDP contracted 0.7% q/q and was likely affected by falling consumer spending linked to the introduction of restrictions to tackle the spread of the virus. Inflation followed the global trend coming in at 5% for Europe as a whole.

The rise in interest rate expectations was beneficial for the US dollar, with the euro left trading below 1.12 by the end of the week. Weakness was also felt in crypto currencies as the presumed return to more 'normal' monetary policy dented their mystical appeal. It was a similar story for precious metals also lower this month for similar reasons. Energy prices rose, however, which suggests it will take longer to normalise inflation as a result.

Investment grade credit

If it was a bad month for government bonds it was worse still for investment grade credit where excess (to government bonds) returns were negative.

After a slow start to the year, spreads widened consistent with weakness in other 'risk' assets such as equities. Contextually, global IG spreads ended the month wider than was the case at the worst point of the November sell-off. At 109bps, spreads are the widest since late 2020 **(see chart of the week)** and just below 10% wider year-to-date. On a risk-adjusted basis it was higher quality credit (eg, AAAs) that performed worst.

It was also a month of heavy new issuance, at least to start with. This faded into the end of January as the results seasons commenced and risk aversion rose. So far, results have been skewed towards the banking sector and have come in reasonably strongly with writebacks, benign credit conditions and improving margins and loans.

We remain neutral on the outlook for credit spreads even after the widening seen in January. Valuations have improved but are tighter than short and long-term averages. While the rise in expectations for interest rates has been a concern, even with five rate rises priced for the year this still leaves rates low and not yet contractionary. The economic outlook also looks supportive; though more muted than 2020. Meanwhile, in spite of rising M&A activity and speculation we expect credit quality to improve in the coming months and for new issuance to be lower than last year.

High yield credit & leveraged loans

US high yield bond prices declined again over the week and the asset class is on track for its weakest January performance on record (-2.35%) with fresh hawkish remarks from Fed Chair reverberating through risk markets. The ICE BofA US HY CP Constrained Index returned -1.35% and spreads were 31bps wider over the week. The asset class reported its third consecutive weekly outflow with a $2.8bn withdrawal, according to Lipper.

Leveraged loan prices were not immune to the week's volatility, declining $0.26, which roughly halve the YTD gain. That said, the J.P. Morgan Leveraged Loan index has returned 0.48% YTD. The asset class reported a $2bn inflow over the week, the second highest inflow on record.

European High Yield (EHY) is finishing January with another week of market weakness resulting in increasingly wider spreads and higher yields. It was the weakest week yet for the year but this time with single Bs underperforming BBs and CCCs. Outflows from the asset class continued, both via ETFs and managed accounts with only short term EHY still experiencing inflows. EHY has experienced just over €500m exiting from the asset class YTD. Still, on a relative basis, outflows have been muted if compared to previous years with only 0.5% of the high yield universe AUM exiting retail funds. It has mainly been ETFs that have been driving the outflows, which could be a signal that the marginal high yield buyer is leaving the market. ETFs are now trading at a discount, a rare occurrence. Markets experienced another week of steady selling with any day's market rally being an opportunity to reduce risk especially of longer duration securities. New issuance flow was somewhat subdued with only three new issues totalling €1.1bn, though the primary market pipeline continues to grow with more potential names being added to the list.

In credit rating news, more ratings were upgraded, this time a double upgrade for Avis to BB- (from B) by S&P citing better than expected operating performance in 2021 with expectations that this will continue well into 2022. Occidental Petroleum was upgraded by S&P to BB+ (from BB) stable given expectations of higher energy prices as well as continued deleveraging.

In issuer specific news, Adler announced it is delaying publication of its annual numbers given that is taking longer than was expected for PWC to finish a forensic review of the company's books (comes on the back of the accusations made against the company last year.)

Asian credit

PTT Exploration & Production PCL (PTTEP) may eventually increase its share in the Yadana gas field project in Myanmar because TotalEnergies (operator, holds a 31.2% in the project) will be withdrawing from the project. TotalEnergies will continue to operate the Yadana gas field for another six months. The company cited the human rights violations in Myanmar following the coup in Feb 2021. Another JV partner Chevron (28.3%) is also reportedly looking to exit the project.

Shimao Group has reportedly put 34 projects up for sale in China. These properties comprise residential, office, commercial and hotel projects in 17 cities. Shimao is looking to sell 15 projects for CNY42.2bn ($6.7bn). The remaining 19 projects are JV or projects at early investment stage.

S&P has placed the BB issuer credit rating of Logan Group and the BB- on the senior unsecured on Credit Watch negative. The negative ratings action reflects previously unreported debt by Logan and the risk that S&P may alter its view on Logan's management and governance ability with regards to disclosure and transparency.

Structured credit

The US Agency MBS market outperformed other high-quality fixed income assets last week, posting a positive 2bps total return. Spreads widening in response to a hastened taper and more hawkish Fed has been manageable, though we expect more weakness in the coming months. The commercial real estate market continues to perform well. Transaction volumes set a new record of $808bn in 2021. Growth was driven by Hotel and Multifamily at 195% and 164%, respectively. Commercial property prices rose by a record 22.9% y/y in December 2021, which was the 16th month of accelerating y/y growth. CRE price growth has outpaced housing price growth for two consecutive months.

Emerging markets

In Turkey president Erdogan has replaced the head of TurkStat for the fourth time in 20 months. TurkStat is responsible for calculation official measures of Turkey such as inflation and unemployment. Turkey's latest inflation figures are released this Thursday.

The US, EU and UK are looking to levy sanctions on Russia. The UK is considering targeting individuals and corporates of direct interest to the Russian state. The US is looking to levy sanctions immediately in response to Russian cyber-attacks on Ukraine, with the US Senate closing in on a deal that would targeting Russia's financial industry. In central bank news, Hungary took a more hawkish stance and hiked interest rates by a higher-than-expected 50bps. Elsewhere, Chile hiked by 150bps, South Africa hiked by 25bps, and Columbia followed suit with a 100bps hike. Chile exceeded expectations of 100bps due to stubbornly high inflation at 7.2%.

Commodities

The market continued its strong run led by energy. US natural gas prices have rallied 22.6% driven by colder weather on the US east coast, despite the recent surge, US gas is still x6 cheaper than in Europe. Heating oil also rallied 2.8% due to tightness in supply.

The rally in agriculture continued with corn up 3.2% and wheat prices edging higher (+0.8%). Record input prices, notably surging fertilizer prices, have supported markets recent weeks. Russian tensions with Ukraine have been exacerbating the issue due to further driving up natural gas prices; natural gas is a key input for nitrogen-based fertilizers. Russia and Ukraine are also the first and fourth largest wheat exporters so the prospect of invasion and resulting export disruption would likely have a global impact.

Responsible investments

With a rough start to the year for markets, there's nothing better to look forward to than new ESG regulations for banks in Europe! The European Banking Authority (EBA) has launched a list of reporting requirements for banks in the region to help provide clarity on their alignment with the Paris Agreement. Numerous quantitative pieces of data, including exposure to carbon-related assets and exposure to both chronic and acute climate change events, will need to be disclosed twice a year. This is in addition to detailing how they are incorporating ESG into governance structures, strategies and business models. Although the regulations still need to be accepted by the European Commission, it's clear the EBA is looking to remove the risk of banks cherry picking from their ESG results to disclose and create a common ESG language in the industry for banks.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views
31st January 2022

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	▪ 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 economic growth, with high expectations for tightening at March FOMC. The pullback in forecasted liquidity has left opportunity for market volatility. ▪ Uncertainty remains elevated as the Omicron variant spreads, inflation fears revive, supply disruptions continue, 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: Omicron worsens. Supply chain disruptions and inflation persist to H2 2022. Simultaneous low unemployment, hiking and slowing growth could cause a sell off or recession.
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 ▪ ECB to lean against rising financing rates	▪ 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	▪ There is room for the Dollar to strengthen further given our belief in the US leading the economic and monetary policy recovery ▪ However, experience of past cycles suggests the Dollar fares less well at the start of a cycle, turn neutral USD for now	▪ The ECB moves to tighten monetary policy ▪ The Fed starts to push back against market pricing ▪ More expansive China credit cycle
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	▪ Selective opportunities ▪ Aggressive Fed pricing may now open the door to selective 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 ▪ 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 ▪ DM tightening financial conditions will unevenly impact EM credit and EMFX as many countries have already responded to inflation through hikes ▪ 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).	▪ Spillover from China's credit woes or Russia-Ukraine aggression ▪ 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 DM
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.2021 Q3 earnings supported this, now looking to Q4 results. ▪ Good fundamentals, with strong balance sheet management, M&A 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 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 are nearly to all-time tights, although credit quality has improved through defaults and ample liquidity Runway left in HY recovery trade rising stars ▪ Bank loans are attractive as they have shown better performance relative to corporates, although flows amid hiking expectations have increased valuations ▪ The best performing parts of these sectors have been the most volatile and lowest quality. ▪ Defaults are set to continue near historic lows due to the rapid recovery and ability to remove near-term maturities by companies across the credit spectrum.	▪ The reach for yield continues to suppress spreads, although mounting negative headwinds (inflation, supply disruptions) are increasing pressure for higher yields. ▪ Waves of ratings upgrade begin to occur into this year. ▪ There are few exogenous shocks that shake the tight spread environment.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Overall, the risk/reward mix remains asymmetric. ▪ Valuations continue to widen on hawkish language; however, valuations remain rich and carry in many Specified Pools and CMO deals remain unattractive. ▪ Spreads still tight to similar Fed taper and QT regimes ▪ The Fed's taper was well advertised and saw a muted market reaction upon official announcement.	▪ Housing activity slows considerably and prepays move back down to normal levels, without denting households' ability to service mortgages. ▪ Uncertainty the Fed taper schedule and long-term position
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Our preference remains for Non-Agency RMBS and CLOs ▪ Spread tightening seems somewhat excessive per credit quality but seeing repricing risk premiums in new issues. ▪ Keeping an eye on sentinel slight upticks in defaults ▪ RMBS: Housing continues to outperform in the recovery with constrained supply and strong balance sheets & demographics. Affordability waning but near average. Anticipating more supply in 2022. Valuations less compelling but offer stable carry in de-risked portfolios. ▪ CMBS: Most segments maintain strong fundamentals with retail & hospitality improving. Spreads outperforming other structured segments. ▪ CLOs: Attractive with fundamentals, waiting for issue pickup	▪ Attractive shorter duration deals coming into market, provide less carry ▪ Changes in consumer behavior in travel and retail last post-pandemic. ▪ Work From Home continues full steam-ahead post-pandemic (positive for RMBS, negative for CMBS). ▪ SOFR transition 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 ▪ o/w Natural Gas	▪ Renewed Covid lockdowns ▪ Global Recession