INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

In Credit

13 SEPTEMBER 2021

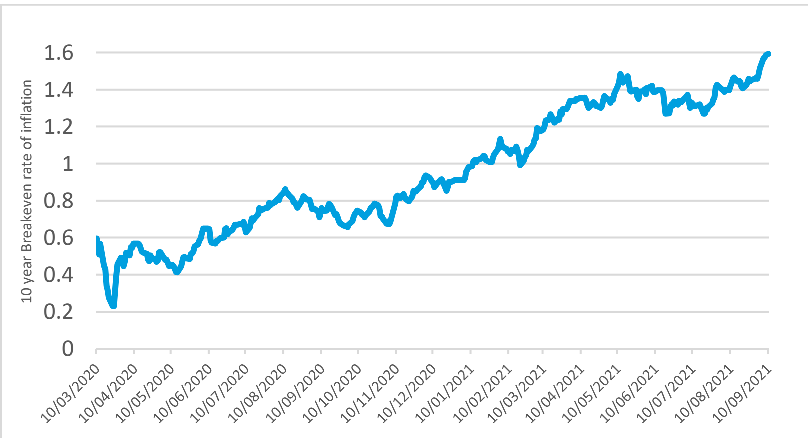
When a taper is not a taper.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.33%	1 bps	-0.1%	-1.6%
German Bund 10 year	-0.33%	3 bps	-0.4%	-1.9%
UK Gilt 10 year	0.76%	4 bps	0.0%	-4.0%
Japan 10 year	0.05%	1 bps	-0.2%	0.1%
Global Investment Grade	91 bps	-1 bps	-0.0%	0.0%
Euro Investment Grade	85 bps	0 bps	-0.2%	0.1%
US Investment Grade	91 bps	-1 bps	0.0%	0.0%
UK Investment Grade	88 bps	-1 bps	0.0%	-1.3%
Asia Investment Grade	198 bps	-2 bps	0.1%	0.9%
Euro High Yield	305 bps	-5 bps	0.2%	4.0%
US High Yield	311 bps	-3 bps	0.3%	5.0%
Asia High Yield	681 bps	-2 bps	-1.2%	-2.8%
EM Sovereign	310 bps	0 bps	0.2%	0.6%
EM Local	5.1%	5 bps	-0.5%	-3.5%
EM Corporate	300 bps	-3 bps	0.2%	2.4%
Bloomberg Barclays US Munis	1.0%	0 bps	0.0%	1.5%
Taxable Munis	2.1%	1 bps	0.0%	2.3%
Bloomberg Barclays US MBS	32 bps	-1 bps	0.0%	-0.3%
Bloomberg Commodity Index	207.94	0.0%	1.2%	24.4%
EUR	1.1780	-0.6%	0.0%	-3.3%
JPY	110.13	-0.2%	0.1%	-6.0%
GBP	1.3825	-0.2%	0.6%	1.2%

Source: Bloomberg, Merrill Lynch, as at 13 September 2021.

Chart of the week: German 10-year inflation expectations



Source: Bloomberg, Columbia Threadneedle Investments, as at 10 September 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

Core government bond markets ended the week with a better tone, even as the European Central Bank announced its intentions to modestly reduce asset purchases, and as the ECB increased forecasts for economic growth and for inflation. The ECB notched higher its GDP expectations to 5.0% for this year (from 4.6% in June and 4.0% in March). The ECB sees inflation heading to 2.2% for this year but falling again next year (1.7%) and the year after (1.5%), In short, these estimates still have inflation below target in the longer term and that means there is little reason to expect any drastic change in monetary policy conditions. It is noteworthy that market-based inflation expectations (for 10 years) reached the highest level since 2013 at one-point last week of nearly 1.6% **(see chart of the week)**.

While the ECB was painting a rosier outlook for growth the UK seems to have ground to a halt in the wake of the delta variant. GDP data for July barely registered an increase (0.1%), with a slowdown noted in the service sector. Though the plateauing in growth has been acknowledged by the Bank of England, there has been more hawkish rhetoric recently that has helped sterling to rally. We have Consumer Price Inflation data later this week.

Over in the US, jobless claims showed another fall – prompted perhaps by an end to certain Covid benefits – to a post pandemic low of only 310k. This week also brings Consumer Price Inflation data in the US.

Investment grade credit

What ever happened to spread market volalility? We have mentioned many times that volatility so evident last year has all but disappeared. The Global IG spread, which is presently at 92bps over government bonds, has been within 3bps of this level since the end of April and the difference between the widest spread and tightest spread this year is only 14bps. For context, last year that number was over 240bps. To be fair, few would argue 2020 was anything other than exceptional and that number reflects this. However, when we look at the standard deviation of spreads this year stacks up as the lowest in voltility terms since 2004 and 2006. You will recall the years that preceded the Global Financial Crisis were notable for very tight spreads accompanied by very low spread volatility.

Last week saw the post summer reopening of primary markets with very high volumes of supply, especially from financials. This new issuance has generally been met with good demand and has performed well. We thought it worth noting that Eli Lilly brought one of the very longest maturity deals ever seen in the euro market with a 40-year bond. Lilly, the A rated, US pharmaceutucal company borrowed for four decades at a coupon rate of 1.375%.

High yield credit

US high yield valuations tightened for the third consecutive week, albeit at a more modest pace as the asset class weathered the ongoing uncertainty around the Delta variant spread, the end of extended US unemployment benefits and expectations for a heavy primary calendar. The ICE BofA US HY CP Constrained index returned 0.30% over the week and spreads were 10bps tighter. The yield-to-worst of the index has returned to within 10bps of its all-time-low of 3.73% seen in early July. According to Lipper, the asset class experienced its largest inflow since April with a $710m contribution over the week.

European high yield had another firm week as spreads tightened 5bps to 305bps with CCCs again strongly outperforming BBs. Primary markets re-opened, with two new issues, Cellnex and EDP for a total of €3.1bn. The long-expected tidal wave of new supply is expected to start this week. Flows were flat for the week with money coming in via ETFs but exiting via managed accounts. Trading was overall firm as market participants prepared for the upcoming expected new issuance and given last week's US holiday and major research conferences.

M&A news flow remains strong supporting upcoming primary supply given likely refinancing requirements. Latest on the telecoms front was the announcement by Deutsche Telecom that it is selling it NL Mobil unit to Apax for €1.5bn. On the gaming front, 888 Holdings reported it is buying the non-US William Hill assets (specifically online related assets) in a £2bn+ bid. In healthcare, Avantor announced the purchase of Masterflex (propriety fluid transfer technology) for an all cash $2.9bn acquisition. In retail, Spectrum brands, a consumers products group, flagged the sale of HHI for $3bn in net proceeds with $1bn to be used to reduce leverage. Finally, more news on the long-awaited acquisition of Monte de Paschi by Unicredit. It is now suggested that UniCredit will only acquire some, not all, of the MONTE assets, specifically 56% of the assets and 78% of the bank branches.

In auto news, Ford announced it is ceasing vehicle production in India, closing the two plants there. This means a restructuring charge of $1.7bn. This is all part of a plan to fix the international business as well as restore profitability and achieve stronger margins.

Leveraged loans

The average price of the J.P. Morgan Leveraged Loan index rose a modest $0.07 over the week. Support was driven by a pick-up in retail inflows and steady CLO demand, which is expected to be enough to offset the sizeable but well telegraphed upcoming new issue calendar. Loan yields (3-year) and spreads (3-year) decreased 2bps and 3bps over the past week to 4.75% and 423bps. The asset class saw a $717m inflow over the week, marking the 34th inflow over the last 35 weeks.

Structured credit

The US Agency MBS market was essentially flat last week on relatively rangebound rates. More broadly speaking, spreads have widened recently on expected taper news and faster prepays. Investors are looking for a taper that starts near the end of year as the US Federal Reserve has met its inflation target and sees continued improvement in the labour market. Meanwhile, home prices continue to accelerat; HPA is now up 18.6% y/y, a new record. Both new and existing home sales are down y/y given low supply. CMBS remains is a Covid-surge risk especially as it relates to business/group travel; however, spreads have been hanging in pretty well to date.

Asian credit

There were several positive ratings actions during the previous week. Moody's raised the ratings outlook of JSW Steel from stable to positive because the company's solid operating performance, driven by demand from residential construction, automotive and white goods manufacturing will support its deleveraging trend. S&P raised the ratings outlook of Aluminum Corp of China Ltd (Chalco) to positive, thanks to favourable aluminum and copper demand that will drive the credit metrics improvement. S&P raised the stand-alone credit profile of Chalco from "bb-" to "bb". S&P upgraded Tingyi Holding Corp by a notch to A- to reflect the scope for the company's market position to strengthen over the next 12-18 months, helped by solid execution, production innovation and its established distribution network.

Moody's has downgraded the corporate family rating of China Evergrande from Caa1 to Ca and its senior unsecured ratings from Caa2 to C. Evergrande has high liquidity and default risks over the next 6-12 months due to its sizable maturing debt over the next 6-12 months.

Emerging markets

Emerging markets had a flat week accompanied by strong inflows of $1.7bn, the highest level in 10 weeks with a sharp increase into local currency bond funds (~$800m, largely into China focused bond funds.) This brings year-to-date flows to +$58bn.

In central bank news, Ukraine hiked 50bps to 8.5%, as expected while Russian surprised the market by hiking only 25bps to 6.75%, leaving room for another hike in the coming months. There has been some divergency in EM monetary policy with parts of EMD world, especially LATAM, hiking rates, while in Asia, only Bank of Korea has hiked rates. This is due to greater concern in Asia, for economic growth and maintaining ample liquidity in the market, versus higher inflation concerns.

In primary markets, Phosagro, the Russian phosphate company came out with a $500m bond, which was more than 6x oversubscribed.

In unusual currency news, El Salvador became the first country to adopt bitcoin as an official currency. Bitcoin sold off on the announcement.

Commodities

It was a fairly flat week for the commodity complex, though this disguises a disparity in performance between strong base metals markets and weakness in other areas.

Ongoing demand from China and fears that a military coup in Guinea will lead to a disruption in Bauxite exports helped push Aluminium prices higher by around 7.5% in the last five days.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

13th September 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	▪ 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 £ €	▪ 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, 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 Soybenas	▪ US China trade war ▪ Renewed Covid lockdowns