COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

15 FEBRUARY 2021

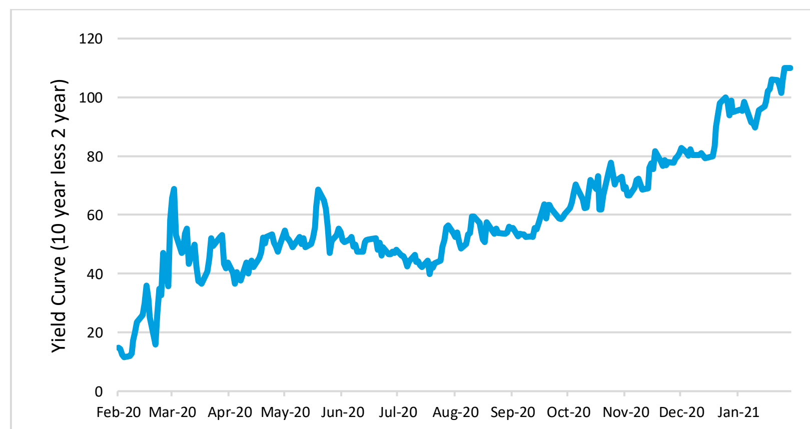
Reflating a bubble.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.21%	4 bps	-0.7%	-1.8%
German Bund 10 year	-0.39%	6 bps	-0.9%	-1.3%
UK Gilt 10 year	0.57%	9 bps	-2.6%	-4.3%
Japan 10 year	0.08%	2 bps	-0.1%	-0.3%
Global Investment Grade	97 bps	-1 bps	-0.3%	-1.1%
Euro Investment Grade	88 bps	0 bps	0.0%	-0.1%
US Investment Grade	97 bps	-2 bps	-0.4%	-1.6%
UK Investment Grade	92 bps	-3 bps	-0.9%	-1.9%
Asia Investment Grade	224 bps	0 bps	0.3%	0.3%
Euro High Yield	333 bps	-2 bps	0.8%	1.3%
US High Yield	348 bps	-10 bps	1.0%	1.4%
Asia High Yield	586 bps	7 bps	0.0%	-0.1%
EM Sovereign	312 bps	1 bps	0.3%	-0.9%
EM Local	4.3%	4 bps	0.9%	-0.2%
EM Corporate	313 bps	-3 bps	0.6%	0.5%
Bloomberg Barclays US Munis	0.9%	-5 bps	0.4%	1.0%
Taxable Munis	2.2%	0 bps	-0.8%	-0.8%
Bloomberg Barclays US MBS	17 bps	5 bps	-0.2%	-0.1%
Bloomberg Commodity Index	179.47	1.9%	5.0%	7.7%
EUR	1.2128	0.6%	-0.1%	-0.8%
JPY	105.33	0.4%	-0.2%	-1.5%
GBP	1.3905	0.8%	1.0%	1.3%

Source: Bloomberg, Merrill Lynch, as at 15 February 2021.

Chart of the week: Steeper US Yield Curve, LTM



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

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Macro / government bonds

It was Presidents Day in the US on 15 February and we imagine ex-President Trump will be celebrating more than most after being acquitted in his second impeachment vote. There was, however, less to celebrate in government bond land.

US bond yields continue to rise driven by increasing inflation expectations. Specifically, 10-year yields reached 1.21% with break-even yields for the same maturity at 2.23%, their highest level since 2014. This theme is more of a US phenomenon than in Europe or the UK. Indeed, in addition to the ongoing debate about the fiscal package in the US, that economy seems to be doing better than the eurozone, Japan or UK at least as measured by the PMIs. The reflation trade is also visible in the steepening of the US curve where the difference between 10-year and 2-year bonds at nearly 1.1% is very different to the inversion of the curve in evidence in the late summer of 2019 **(see chart of the week)**.

In the UK, there were a couple of things to celebrate. The vaccination rollout continues at pace and it appears that around 25% of the adult population have had a jab by last weekend. Meanwhile, GDP growth for Q4 came in at 1%, which was stronger than anticipated. In Italy, Mario Draghi will be the next leader of the country. Italian spreads are 20% tighter this year with yields bucking the global trend and lower in 2021 as a whole.

Investment grade credit

Corporate bond spreads were little moved in the last week.

The reflation trade, described earlier, had little influence on the direction of the market though it remains worth watching; certainly if monetary policy conditions need to be tightened sooner than expected. Policy support has, of course, been a major support for risk markets in the last year.
Global investment grade spreads at 97bps are around 6% tighter this year, with sterling credit the slight outperformer. Investment grade markets have lagged their high yield cousins where spreads are 10% better so far in 2021. The greater interest rate sensitivity of investment grade has also affected total returns as government bond moves weight on the market.

High yield credit

US high yield bond yields declined to a fresh record low over the past week amid mixed price action in stocks, treasuries and commodities as February's reflation rally took a breather. The ICE BofA US HY CP Constrained Index returned 0.29% while spreads were 9bps tighter. The yield-to-worst on the index finished the week at 3.92%. According to Lipper, the asset class reported a modest outflow of $228m; year-to-date outflows total $1.1bn.

European high yield had a steady week, experiencing only 2bps of tightening. Single B's and CCC's outperformed BB's as Covid-sensitive and more cyclical names behaved strongly. The asset class continued to experience small net outflows, mainly coming via ETFs. Spread compression persisted as buyers looked for extra yield with the willingness to go down the rating curve to get that yield.

The primary market was busy with €6.9bn issued, bringing the month-to-date number to €10.3bn, a record for the month of February and €26.3bn year-to-date. Issuers included Cellnex (€2bn), Atlantia (€1bn), Iceland (£250 Mn), and ASDA (£2.75bn with the largest ever single tranche in

European high yield at £2.25bn). In the leisure space, Carnival Cruise issued an upsized $3.5bn in US dollar bonds, half to be used for refinancing purposes but also to boost its liquidity position to a level that should cover the firm's cash needs through May 2022.

As an indication of the strength of the market, Vallourec's (metals and mining) bonds priced in the high 80s just before going into the restructuring lock-up even as S&P moved the issuer's rating from CC to SD on principal non-payment. This is more than twice the coverage that is normally expected for defaulted securities.

In issuer specific news, positive news for Valeo (French auto parts) as the European Investment Bank approved a €600m loan to finance European research projects into CO2 emission reduction.

Leveraged loans

Leveraged loan prices rose modestly over the past week amid ongoing inflows and heavy CLO origination. Leveraged loan mutual funds posted a fifth consecutive weekly inflow of $1.05bn, increasing year-to-date inflows to $5.8bn. The average price of the J.P. Morgan Leveraged Loan index increased $0.15 to $98.24 over the week. Yields and spreads (3-year) decreased 7bps and 8bps over the past week to 4.70% (a record low) and 442bps respectively.

Emerging markets

The asset class was relatively subdued last week with a light primary market, as much of Asia was off due to Lunar New Year. EM sovereign spreads widened 1bps while EM corporates tightened in 3bps. EM local rates were weaker, but this was offset by positive EM FX performance of 70 bps.

The strong inflows since the start of the year slowed down, at the margin, but were still a healthy $3bn last week, equally split between hard currency and local EM, but with the majority going into managed accounts.

In credit rating news, Ethiopia was downgraded by S&P to B- (from B), credit watch negative due to the weak external balance sheet and on debt restructuring plans. More positively, Moody's upgraded Lithuania's foreign debt rating to A2 from A3.

Central bank meetings this last week resulted in two countries keeping rates on hold (Peru at 0.25% and Russia at 4.25%) while Mexico cut rates by 25bps to 4%. Both Peru and Russia signalled that further rate cuts were not likely as Peru indicated, instead, the use of liquidity injections to help the economy. Russia was directly more hawkish, saying that there would not be any more rate cuts given the uncertainty regarding the ruble and with inflation risks now to the upside.

In country specific news, Brazil's President Bolsonaro promised another $1bn of handouts in the latest effort to help revive the economy.

Commodities

The commodity index rallied 1.9% last week, taking year-to-date returns to 7.7%.

Energy markets rallied 3.3% on the week. WTI and Brent rallied 4.6% and 4.7% respectively. Market strength was driven by inventory drawdowns. Crude oil curves remain in backwardation, providing investors with positive roll return. The push for carbon neutrality is disincentivizing investment in oil projects, as evidenced by the lack of pick-up in US shale production. There is concern this will constrain supply in the near term, pushing prices higher. In Europe, strike risk within the continent's largest producer Equinor threatens shutdowns at several sites.

Industrial metals rallied 4.3% over last week. Notably, copper rose by 4.5% to the highest level since 2012, amid tight supply and strong demand. Production from 25 of the largest producers indicates 2021 will be a deficit year for copper.

In agriculture, the market digested the WASDE report, which was mildly supportive for wheat and beans but somewhat bearish for corn. The report cited reduced feed demand for corn leading to higher-ending stocks. Corn declined by 1.9% last week.

In precious metals, gold and silver rallied modestly, 0.6% and 1.2% respectively. Platinum rallied 11.8% to 5-year highs. This can be attributed to the demand recovery from the auto sector given the metal's use in catalytic converters.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

15th February 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	■ 2021 has started with continued positive credit performance – and not for nothing: fundamentals in 2021 should continue to improve as economic activity normalizes amid more widespread vaccination. ■ Despite this outlook, valuations matter. Most spread sectors are well inside long-term averages. ■ We have likely already seen peak liquidity in financial markets. We do not expect material tightening in financial conditions next year, but spreads at these levels no longer offer cushion for unforeseen hiccups. ■ We have a modestly positive outlook but realistic returns are lower than in 2020.	■ Moving to neutral, risks are two-sided. ■ A recovering economy propels spreads to all-time tights. ■ The recovery gets bungled by vaccine delays, geopolitical interruptions, or a limping back to normality in the services sector
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long £ €	■ Renewed virus concerns and economic disruption to keep nominal growth subdued ■ Reflation credibility still low, although risks from fiscal policy ■ Fed QE and high personal savings underpin demand for treasuries ■ ECB bond buying scheme supports Eurozone market ■ Duration remains best hedge for further risk asset correction	■ Very aggressive re-normalisation of consumption ■ Permanent fiscal policy shift rebuilds reflationary credibility and raises r* ■ Fiscal largesse steepens curves on issuance 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 ■ Failure to pass substantial fiscal package in US
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ Favourable advanced economy policy settings support EM assets in near term ■ EM real interest rates relatively attractive, curves steep	■ Sharp escalation in global risk aversion ■ EM funding crises drive curves higher and steeper
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	■ EM economies have been given very long leashes to respond to COVID: deficits and debt have skyrocketed with no plans for reigning them in. Any slowdown will likely exacerbate these 'back burner' issues. ■ Valuations are still a slight benefit to EM, particularly EM HY credits. ■ Low yields, lots of liquidity, and global recovery still could provide tailwinds for EM in 2021.	■ 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. ■ Governments show little willingness to address deficits post-COVID.
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	■ IG companies continue to adapt well to the economic environment, given that they are the best-in-class operators in their industries. ■ Valuations are the biggest drawback: with spreads this tight, widening could very quickly more than offset carry. ■ Technicals remain strong, especially as global investors survey the universe of high-quality assets and see extremely low government bond yields.	■ IG bonds further cement their place in global investors' portfolios as safe assets, replacing government bonds. ■ Management teams eschew M&A and shareholder return in order to continue to pay down debt during the recovery.
High Yield Credit	Under-weight -2 -1 0 +1 +2 Over-weight	■ Spreads are inside LT averages, even adjusting for the better quality of today's index. But higher yields give more cushion than slightly higher quality bonds. ■ The ability to access financing has dramatically improved the prospects for many companies, especially for COVID-affected industries. ■ The positive effects of easy financial conditions hit HY later than higher quality sectors, and tighter conditions will hit HY first.	■ Upside risks include: intensified reach for yield keeps drawing new investors, M&A lifts HY companies into larger IG conglomerates. ■ Downside risks include:travel & leisure habits slowly revert to pre-COVID, commodity sell-offs, or financial conditions suddenly tightening.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ Fed buying has overwhelmed highly negative fundamentals, as seen by the near-zero spreads in bonds the Fed buys and poor performance elsewhere. ■ Fed buying cannot be expected to increase in 2021, exposing negative fundamentals and valuations ■ Prepays remain and will remain high, with >70% of mortgages having incentive to refinance.	■ 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	■ RMBS: Housing has been a major outperformer in this recovery, as demand rises and inventory remains low. Strong household balance sheets amongst homeowners has kept fundamentals strong as well. However, many of these bonds are now call-constrained. ■ CMBS: vaccine news reminded investors that a post-COVID world will exist, and CMBS short covering has been fast & furious.	■ Changes in consumer behaviour in travel and retail last post-pandemic. ■ Work From Home continues full-steam-ahead post-pandemic. ■ Built-up savings from fiscal stimulus/enhanced unemployment benefits are drawn down and mortgage forbearance increases.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	■ o/w Copper vs Aluminium ■ o/w Lead vs Zinc ■ o/w Soybeans vs Corn ■ u/w Sugar ■ u/w WTI	■ Oil production disruption

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