COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

28 JUNE 2021

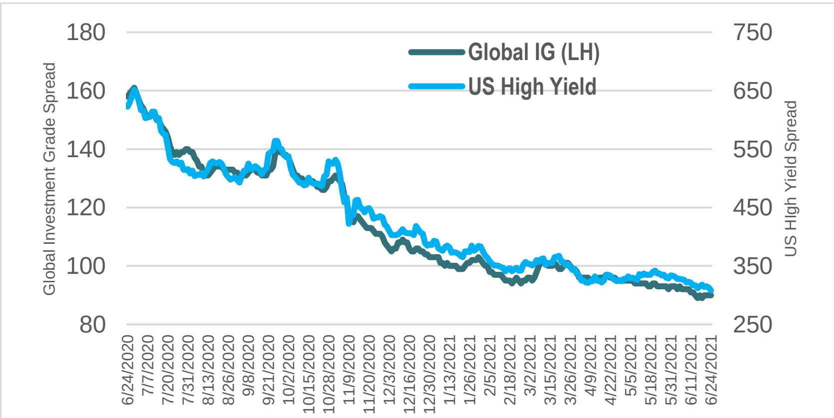
Quieter into the quarter end.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.51%	7 bps	0.3%	-3.3%
German Bund 10 year	-0.17%	3 bps	0.1%	-3.1%
UK Gilt 10 year	0.76%	0 bps	0.2%	-6.3%
Japan 10 year	0.06%	0 bps	0.1%	-0.1%
Global Investment Grade	89 bps	0 bps	0.6%	-1.5%
Euro Investment Grade	83 bps	-1 bps	0.2%	-0.6%
US Investment Grade	86 bps	-1 bps	0.9%	-1.8%
UK Investment Grade	90 bps	0 bps	0.4%	-2.9%
Asia Investment Grade	201 bps	-1 bps	0.7%	-0.7%
Euro High Yield	301 bps	0 bps	0.6%	3.0%
US High Yield	304 bps	-14 bps	1.1%	3.4%
Asia High Yield	575 bps	10 bps	-1.0%	0.8%
EM Sovereign	306 bps	-5 bps	0.8%	-1.1%
EM Local	5.0%	4 bps	-0.8%	-3.0%
EM Corporate	289 bps	-3 bps	0.7%	1.1%
Bloomberg Barclays US Munis	1.0%	3 bps	0.1%	0.9%
Taxable Munis	2.3%	8 bps	1.1%	-0.7%
Bloomberg Barclays US MBS	25 bps	-6 bps	-0.2%	-0.9%
Bloomberg Commodity Index	197.81	1.7%	-0.4%	18.4%
EUR	1.1906	0.6%	-2.4%	-2.3%
JPY	110.96	-0.5%	-1.1%	-6.7%
GBP	1.3888	0.5%	-2.3%	1.5%

Source: Bloomberg, Merrill Lynch, as at 25 June 2021.

Chart of the week: Credit Market spreads – LTM



Source: Bloomberg, Columbia Threadneedle Investments, as at 24 June 2021.

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Macro / government bonds

The ‘roller coaster ride’ for US bond prices, post FOMC, has started to level out though yields were a little higher last week. The benchmark US 10-year yields around 1.5%. This places market levels close to the mid-point of the range for Q2,21, which has been between 1.44% (10 June) to 1.74% (end March). Yield curves have flattened this quarter though steepened somewhat last week. The reopening of economies has reinvigorated business and consumer sentiment in most areas. In terms of businesses, composite PMI data showed a sharp gain in Europe led by Germany but a fall in the US, albeit from last month’s very high level. Likewise, European consumer confidence reached its highest level since 2018 while the German IFO business climate survey recorded the most optimism since 2018.

US Federal Reserve speakers (including Powell) sought to reassure markets that interest rates are not about to rise any time soon, though they acknowledged that the ‘transitory’ rise in inflation (CPI reached 5% y/y last month) had been greater than anticipated.

In the UK, there was no change in policy rates last week which remain at 0.1%. The Monetary Policy Committee voted (8:1) to maintain the current level of government bond purchases. Like the US Fed, the Bank of England expects to see a temporary rise in inflation and has also upgraded its growth forecasts. Covid-19 cases are rising at the fastest rate since early February while retail sales disappointed.

This week brings Non-Farm Payroll / Employment data in the US (700k expected); the June Consumer Price inflation reading in Europe; and the Mansion House speech in the UK.

Investment grade credit

Unlike US government bond prices, credit market spreads have shown an absence of much volatility this quarter. The Global Investment Grade index, for example, has traded in a very tight range of less than 10bps since the end of March **(see Chart of the week).** Spreads are inside both shorter term and long-run averages.

Last week, US banks passed stress tests and with flying colours. The tests placed on the sector by the Federal Reserve model how banks would weather double digit rates of unemployment and a stockmarket collapse. The ‘pass marks’ pave the way for increased dividends and share buybacks, neither of which is credit market friendly. However, as the starting point in terms of capital is so strong, and the results were largely as expected, there was little market spread response.

High yield credit

US high yield bond spreads tightened to new post-financial crisis lows alongside US equity gains and stable US treasury rates. Further, the primary calendar began to moderate while retail outflows paused. The ICE BofA US HY CP Constrained index returned 0.39% over the week. Spreads tightened 14bps to +314bps. The index yield-to-worst marked a new all-time low of 3.83%. According to Lipper, the asset class broke its seven-week outflow streak with a $189m inflow; YTD outflows total $16.6bn for context.

It was a low volatility week for European high yield in a year, so far, which has had the lowest volatility on record (43% of trading days had spread moves of 1bps or less) as spreads finished unchanged, after an initial mild widening. The asset class experienced a small outflow last week, due to ETFs as managed accounts still saw a small inflow. It was another heavy primary week with €5.2bn over nine issues, slightly skewed towards lower-rated securities. This brings the YTD new issuance size to €74bn, up 125% y/y.

In stock specific news, Adler Real Estate bonds were hit last week due to an unconfirmed rumour of short selling. This was later denied but the damage was done as the price rebound still left bond prices lower overall. In transportation, Europcar announced it had rejected a €2.2bn offer by VW to acquire the car rental company. It appears VW is looking to get back into car rentals, a business it exited in 2006 with the sale of Europcar for €1.2bn to a buyout firm.

On the credit rating side, S&P upgraded Atlantia and Autostrade to BB with positive outlook, post the sale announcement of Autostrade.

Leveraged loans

Leveraged loan prices decreased modestly amid few catalysts and a focus on primary activity. The average price of the J.P. Morgan Leveraged Loan index decreased $0.02 over the past week to $98.6. The average price for BB loans increased $0.01 to $99.43, Single Bs decreased $0.01 to $99.39, and Split B/CCC decreased $0.08 to $91.22. Inflows continued for the 24th consecutive week with a $615m subscription, leaving YTD inflows at $19.7bn. The current inflow streak is the longest since late-'16/early-'17 when 30 consecutive weekly inflows were observed.

Asian credit

Moody's has revised its estimate for India's FY22 economic growth from 13.7% to 9.3% due to the negative impact of its coronavirus second wave. While Moody's expects the lockdown measures to drag down economic activities, it does not expect the impact to be as severe as the first wave. S&P has upgraded the ratings outlook of Xiaomi to positive to reflect the improving operating performance of the company and the cash flow generation over the next 24 months. Xiaomi continues to expand its market share in the smart phone market in China and its revenue from internet services.

Structured credit

The US Agency MBS market posted a positive 7bps return last week, beating its high-quality counterparts significantly. The story, however, was more about the Supreme Court ruling that the structure of FHFA violated separation of powers, allowing President Biden to remove its director Mark Calabria. Calabria was in favour of shrinking the GSE footprint via raising loan level pricing adjustments or capping certain types of riskier loans to bring in more competition. His primary goal was less about affordable housing initiatives; he felt Ginnie Mae could do this. The firing likely sets up the Biden administration to hire a new FHFA director to focus more on the affordable housing aspects, lowering fees for low income borrowers etc. Lowering these fees will make the market a bit more callable (lower rates), but the percentage of the universe impacted is very small.

In CMBS, spreads were mixed: wider at the top of the stack, tighter in conduit mezzanine. Seasoned conduit mezzanine is trading at YTD tights driven by favourable macro conditions and robust economic activity, while recent TSA data suggests that personal travel has resumed to 90% of its pre-Covid levels. Prime Jumbo securitizations continue to see strong sponsorship and Non-QM securitisation activity picked up with six deals pricing last week.

Emerging markets

The week finished positively for EM as sovereign hard currency and corporate spreads tightened 3bps and 5bps respectively, but with higher beta names flat for the period. This was a good recovery given the market weakness in the earlier part of the week, with high yield names underperforming. Local EM was up 80bps, all due to EM FX. For the first time in a while, there were outflows from the asset class, equally split between hard currency and local currency EM bond funds. Within the local currency space, half the outflows related to China focused bond funds.

In central bank news, rate hikes were the focus last week with Hungary (+15 bps to 0.90%); (Czech Republic (+25bps to 0.50%); and Mexico (+25bps to 4.25%). While the Czech Republic was expected to follow the example of the National Bank of Hungary, Mexico's move surprised the market. All cited inflation concerns. This was not the case for the Philippines who kept rates unchanged at 1.5% noting that it saw inflation risks as broadly balanced with weaker domestic demand offsetting higher global demand and the rise in commodity prices.

In what could be a big shot of support for EM countries, the IMF board voted to create an additional $650bn of reserves towards helping struggling nations deal with the economic and financial consequences of the pandemic. The plan goes to the board of governors next for final approval.

Commodities

The commodity index continues to rise last week, led by rising energy and base metals prices.

The oil price headed higher as OPEC continues to display supply discipline while fears of Iran dumping oil on the market faded. US natural gas was up around 8% for weather-related reasons. Precious metals prices were broadly flat while rains in the Midwest meant grains prices were softer.

Responsible investments

Within Europe, the leveraged loans market has seen a jump in issuance of sustainability-linked bonds in the first half of this year, eight times as much compared to 2020. Around $30bn has come to the market year-to-date in this space. Currently, sustainability-linked bond issuance is at $58.6bn so far this year across all areas, already over three times as much as we saw in 2020. Leading the way in the ESG market is Green Bond issuance, also ahead of 2020 issuance so far this year ($274bn in issuance YTD). Total ESG related issuance since 2008 is now approaching $1.5trn.

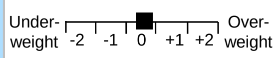
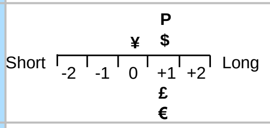
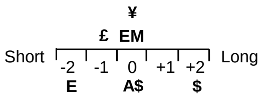
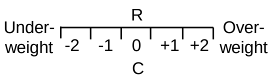
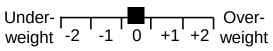
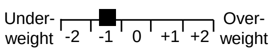
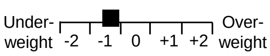
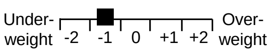
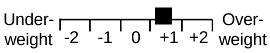
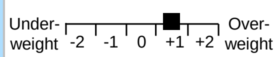
After three years of testing, Lego has released plans of a prototype building block that is made from sustainable materials. It has earmarked around $400m and has 150 employees working on moving away from oil-based plastic. Around 100,000 tons of Lego bricks are made every year.

In the UK, key players in the airline industry have all agreed on interim goals to cut carbon emissions by at least 15% by 2030, vs 2019 numbers, and to cut by 40% come 2040. The hope is that setting these interim goals will help accelerate the progression of reducing emissions and help towards the key 'Net-zero by 2050' goal. Globally, the International Air Transport Association will ask carriers to all adopt the 2050 net-zero goal in an annual meeting later this year.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

28th June 2021

Strategy and positioning (relative to risk free rate)		Views	Risks to our views
Overall Fixed Income Spread Risk		▪ 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)		▪ 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)		▪ 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))		▪ 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)		▪ 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		▪ 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		▪ 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		▪ 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		▪ 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		▪ o/w Copper & Lead vs Zinc ▪ o/w Grains ▪ u/w Livestock ▪ u/w Gold	▪ US China trade war

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