INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

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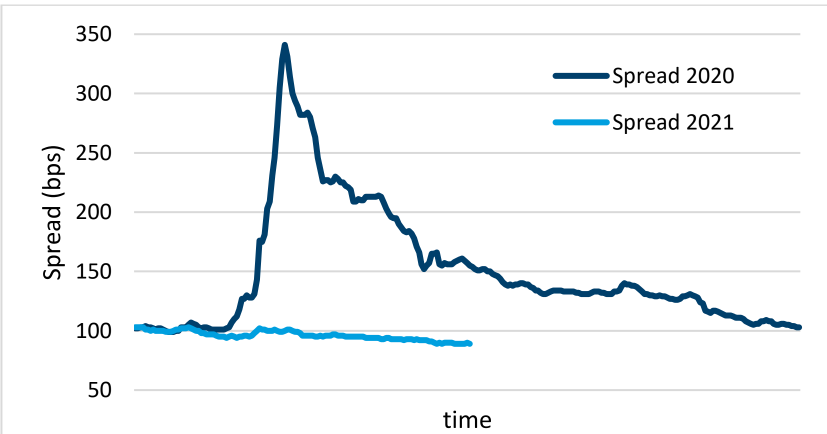
Bonds are back in fashion.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.34%	-8 bps	0.6%	-2.1%
German Bund 10 year	-0.31%	-7 bps	0.6%	-2.2%
UK Gilt 10 year	0.63%	-7 bps	0.8%	-5.1%
Japan 10 year	0.03%	-2 bps	0.3%	0.1%
Global Investment Grade	91 bps	1 bps	0.4%	-0.6%
Euro Investment Grade	84 bps	0 bps	0.4%	-0.1%
US Investment Grade	90 bps	3 bps	0.4%	-0.7%
UK Investment Grade	90 bps	0 bps	0.5%	-2.0%
Asia Investment Grade	211 bps	8 bps	0.2%	-0.4%
Euro High Yield	312 bps	2 bps	0.1%	3.1%
US High Yield	307 bps	3 bps	0.4%	4.1%
Asia High Yield	606 bps	20 bps	-0.5%	0.0%
EM Sovereign	320 bps	4 bps	0.3%	-0.7%
EM Local	5.0%	-2 bps	-0.9%	-4.3%
EM Corporate	304 bps	6 bps	0.2%	1.5%
Bloomberg Barclays US Munis	0.9%	-10 bps	0.7%	1.7%
Taxable Munis	2.1%	-6 bps	0.9%	1.3%
Bloomberg Barclays US MBS	32 bps	4 bps	0.2%	-0.6%
Bloomberg Commodity Index	198.33	-1.6%	-1.1%	19.8%
EUR	1.1848	0.1%	0.2%	-2.8%
JPY	110.19	0.8%	0.9%	-6.2%
GBP	1.3857	0.6%	0.5%	1.7%

Source: Bloomberg, Merrill Lynch, as at 9 July 2021.

Chart of the week: Global IG spreads in 2020 and 2021 (YTD).



Source: Bloomberg, Columbia Threadneedle Investments, as at 6 July 2021.

Macro / government bonds

Core bond yields declined again last week taking the benchmark US 10-year note yield to the lowest point since February at one point before giving up some gains into the weekend. The rally was led by both falling real yields and a modest decline in inflation expectations. In the case of the latter, 10-year breakevens have fallen from nearly 2.6% in May to around 2.3% today. The rally also reflects concerns that the new Covid delta variant could act as an obstacle to the economic growth rebound.

More evidence of rising business confidence came in the form of the final Euro Area composite PMI, which reached a 15-year high. Indeed, Spain recorded the highest level of this measure of business confidence since 2000. German Factory Orders collapsed, however, led lower by falling foreign orders while there was also a surprising decline in Industrial Production. The European Central Bank strategy review ended with littlle change to its objective; albeit an apparent tolerance for occasional breaches of the (now) symmetric 2% inflation target. We note the targeted level of inflation has rarely been achieved let alone breached in the last few years.

Though it remains higher than in 2019/20, the ISM Service Sector Survey in the US came in lower than expected at 60.1 (exp 63.5). The employment component also dipped below the key 50 mark. This week we have Consumer Price Inflation data for June. This is important as the last couple of readings of inflation have exceeded expectations. We also get congressional testimony from US Federal Reserve Chair Powell and the latest Retail Sales data.

UK GDP growth is slowing and rose by 0.8% m/m in May less than an expected 1.5% rise . The three-month-on-three-month growth rate also missed expectations. Next week (19 July) should mark the full reopening of the economy and while Covid cases remain elevated, the link between such cases and hospitalisations appears broken by the successful vaccine rollout in the UK.

Investment grade credit

Investment grade spreads were little moved (again) last week.

We have written about the fall in volatility in credit spreads this year compared to last. **Chart of the week** plots global investment grade spreads through 2020 and this year so far. You can see the amplitude in spreads last year was around 250bps; whereas this year it has been a mere 15bps.

It not often that we get a AAA-rated bond issued these days. Wellcome Trust brought such a deal last week. The bonds offered a 1.5% coupon rate until maturity in 2071 to the sterling market. This was a spread of 55bps to the reference government bond. This week also brings the start of earnings season in the US, with reports from the major banks: JP Morgan, Bank of America, Wells Fargo, Citigroup and Goldman Sachs. We expect the ‘cost of risk’ to fall further.

High yield credit

US high yield bond prices were slightly higher over the week amidst lower interest rates and equity volatility. The ICE BofA US HY CP Constrained Index returned 0.19%. Spreads were 3bps wider to +315bps while yields declined modestly to 3.76%. The asset class experienced its 3rd consecutive weekly inflow with a $728m contribution.

The European high yield market remained resilient last week, in the face of macro and synthetic weakness with spreads widening only 2bps, finishing at 312bps. Inflows picked up with €180m added to the asset class, evenly divided across ETFs and managed accounts.

New issuance continued at a steady pace last week with €3.1bn overall, including a €1bn, two tranche deal from Lufthansa, a €500m deal from Jaguar, taps from Grunenthal and Nomad Foods, and a return to the market deal by Pizza Express. It is interesting to note that the price clearing level for new bonds was wider than has usually been the case, with both Lufthansa and Jaguar having to offer more of a premium relative to their more recent new issues.

In sector news, the auto industry continues to be weighed down by microchip and labour shortages. These issues were seen as affecting the pricing of the aforementioned Jaguar bond but have also been perceived as having a negative impact on the post-Covid UK economic rebound. In issuer specific news, France is having difficulty accepting EU requests for the reorganisation of EDF, with its finance minister saying we 'won't let the EU dismantle EDF'. Expect continued negotiations.

Leveraged loans

The average price of the J.P. Morgan Leveraged Loan Index was unchanged over the week. While loans outperformed during Thursday's market setback, they are underperforming high yield bonds by 21bps thus far in July after underperforming by 80bps during June's rate decline. However, there is no indication of declining demand with the asset class experiencing its 26th consecutive weekly inflow despite the continued decline in yields. According to Lipper, the asset class experienced a $630m contribution, leaving YTD inflows at $28bn.

Structured credit

For the first time in about a year, we can finally say that agency mortgage spreads are not at their all-time tights. Mortgages widened out by about 15bps after the June FOMC meeting but, as volatility subsided, buyers stepped in and spreads retraced tighter. Spreads are clearly still very tight, but the bias is towards wider spreads as the US Fed starts to think about tapering later this year. Within the credit segments of the structured markets, fundamentals, especially the housing fundamental story, remain strong with home price appreciation up 15% year over year bolstered by strong demand, low inventory, and rates remaining low. The valuation story is similar here with spreads between 10-30bps off of their all-time tights. There are some select opportunities sprinkled throughout the market; one of them being credit risk transfers, which have had strong performance and are one of the few sub-sectors that sit wider than pre-Covid spread levels.

Asian credit

The Cyberspace Administration of China has launched a regulatory review and restriction on Chinese internet companies that have listed recently in New York. These companies include Didi Chuxing (ride hailing company), Full Truck Alliance (lorry-hailing and cargo) and Kanzhun (internet recruitment company). These internet companies hold significant consumer data with Didi having 377 million annual active users. Full Truck Alliance had 140 million active monthly users and its data is closely tied to China's national transportation system. Kanzhun, as the largest internet recruitment in China, has 25 million monthly active users. Didi's normal operations are unaffected but it is not allowed to register new users and the Didi app has been removed from app stores.

By way of background, the NPC (National People Congress) passed the Data Security Law (DSL) in June, which emphasises the control over data produced in China. Under DSL, central and local government oversee “core state data”, which encompasses data held by private enterprises. The law also prohibits the provision of data stored onshore to overseas regulator or law enforcement bodies without prior Chinese government approvals. From the Chinese regulator’s perspective, the internet platforms hold substantial sensitive data of Chinese consumers and the regulator is concerned about the access to this personal data.

Vedanta Resources Ltd has launched a consent solicitation to raise the cap on the total debt at the subsidiary guarantor Twin Star Holdings Ltd from $3.6bn to $5bn. This will provide the company with the flexibility to issue more bonds with Twin Star Holdings as the guarantor. Twin Star Holdings can use the additional funds to increase its stake in Vedanta Limited (current stake: 37.1%) or to refinance the upcoming debt maturing at the Vedanta Resources Ltd level. The near-term debt maturity includes the $1bn Vedanta bond that matures in July 2022.

Moody’s has downgraded Thai Oil’s credit rating from Baa2 to Baa3 and revised the outlook to stable (previous: negative) due to the increase in Thai Oil’s net debt to finance its refinery expansion. Thai Oil’s leverage will remain high until at least 2023 because earnings are currently weak due to lower refinery utilisation on the back of pandemic-driven decrease in the demand for transportation fuel.

Emerging markets

In China, the PBOC has announced a cut to the reserve requirement ratio of 50bps for all banks, effective 15 July. The measure means CNY1trn of long-term liquidity will be released into the economy. The weighted average reserve rate requirement for all financial institutions currently stands at 8.9%. The cut follows concerns of cooling Chinese growth following a record expansion in Q1. Chinese businesses have faced surging commodity prices and the state has moved to take action against the dubbed “speculations and hoarders” as a result. The cut raised concerns of bad debts in the banking sector, particularly given the well-publicised struggles of the real estate sector.

On the Covid front, Asia has been hampered by the rapidly spreading delta variant. In Seoul, private gatherings have been banned. Thailand is shutting shopping malls among other establishments and Vietnam is imposing stay of home curbs. In India, there are reports of families selling gold jewellery to meet daily expenses. The good news is that daily cases there have dropped to 37,000.

Commodities

Energy markets coasted lower (-0.6%) as OPEC+ talks were scrapped last week following the Saudi Arabia/UAE disagreement. On the Iranian deal, discussions still look a long way away from adding Iranian crude to the market.

Agriculture was down 5.3% on aggregate. Corn sold off by 10.6% due to lower expected Chinese demand, a stronger Ukrainian crop and wetter weather conditions in the US materialised. There have been concerns of tinderbox conditions in the US Midwest, enhancing the prospect of wildfires. Precious metals were the best performer on the week, up 0.9%. Gold (+1.5%) has been supported by emerging market central bank buying, which has offset recent ETF selling. Overall, gold is one of 2021’s worst performers, down 4.9%.

Responsible investments

Last week we heard that the South Korean government plan to invest $35bn into electric vehicle battery development. By 2030 it hopes to be one of the top players in the EV space, along with neighbours Japan and China.

As part of its plan to become a more eco-friendly operator, the Hong Kong based container ship company Seaspan Corp is looking to raise $500m in what it is calling a “blue transition bond”. The aim is to fund projects such as designing new container ships that will use low carbon emission fuel. Transition bonds are bonds issued in polluting industries, such as oil & gas and transportation companies, that raise money to fund projects to help lower their overall environmental impact. As these companies recognise they will never be completely clean, the bond would not have the ‘green bond’ label some borrowers might compare it to. The ‘blue’ terminology is due to the marine and oceanic nature of the projects Seaspan Corp will partake. This isn’t the first time we have seen blue transition bonds issued, as in 2018 the Seychelles sought funding to support sustainable fisheries.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

12th July 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	▪ 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)	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, 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	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. ▪ 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	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 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	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: 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	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper & Lead vs Zinc ▪ o/w Grains ▪ u/w Livestock ▪ u/w Gold ▪ u/w Natural Gas	▪ US China trade war