INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

2 AUGUST 2021

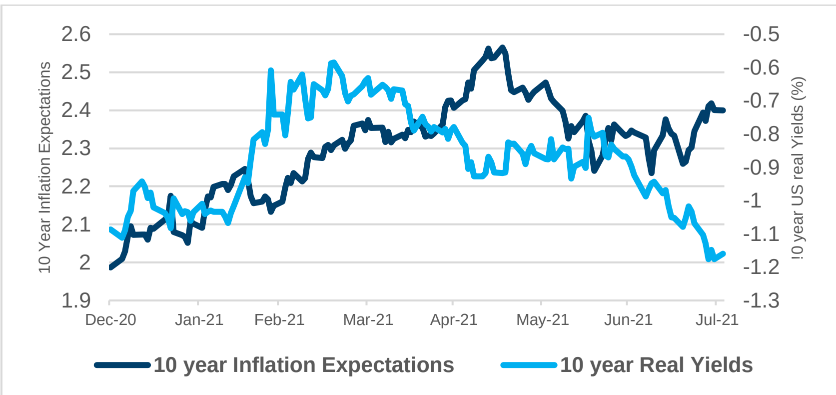
Really low real yields.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.18%	-10 bps	1.3%	-1.4%
German Bund 10 year	-0.48%	-6 bps	1.9%	-0.9%
UK Gilt 10 year	0.54%	-4 bps	2.9%	-3.1%
Japan 10 year	0.02%	0 bps	0.5%	0.4%
Global Investment Grade	93 bps	0 bps	1.2%	0.2%
Euro Investment Grade	85 bps	0 bps	1.2%	0.7%
US Investment Grade	92 bps	0 bps	1.2%	0.1%
UK Investment Grade	91 bps	0 bps	1.5%	-1.0%
Asia Investment Grade	219 bps	7 bps	0.5%	-0.2%
Euro High Yield	323 bps	5 bps	0.4%	3.4%
US High Yield	332 bps	10 bps	0.4%	4.1%
Asia High Yield	699 bps	69 bps	-4.2%	-3.7%
EM Sovereign	325 bps	0 bps	0.5%	-0.5%
EM Local	4.9%	-2 bps	-0.4%	-3.8%
EM Corporate	318 bps	7 bps	0.2%	1.5%
Bloomberg Barclays US Munis	0.9%	-1 bps	0.8%	1.9%
Taxable Munis	2.0%	-3 bps	2.1%	2.5%
Bloomberg Barclays US MBS	31 bps	0 bps	0.6%	-0.1%
Bloomberg Commodity Index	204.77	0.6%	1.8%	23.4%
EUR	1.1878	0.8%	0.1%	-2.8%
JPY	109.27	0.8%	1.3%	-5.8%
GBP	1.3892	1.1%	0.5%	1.7%

Source: Bloomberg, Merrill Lynch, as at 30 July 2021.

Chart of the week: US real yields / inflation expectations – YTD



Source: Bloomberg, Columbia Threadneedle Investments, as at 2 August 2021.

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Macro / government bonds

As we start a new month, we can reflect on another better week and month for core government bonds.

US yields fell by around 25bps in July. The fall was led by declining real yields, which reached an all-time low (since TIPS were introduced in 1996) last week of around -1.18%. Inflation expectations travelled in the opposite direction and rose from around 2.3% at the end of June to 2.4% today at the 10-year point (**see chart of the week)**. Other markets were also better with German Bund yields lower by a similar amount.

While economic data has generally been good (eg, Chicago PMI, Eurozone GDP), there is nervousness about the spread of the delta variant of Covid (in places such as Florida in the US) and whether this will set back the recovery as restrictions are introduced. This week brings the US Employment / Payroll report on Friday (market consensus expects a very strong 900k jobs to be created; this would be highest since August of last year). This will be last employment report before the Jackson Hole symposium. That gathering has been earmarked as a likely time for a strong signal on 'taper timing' in the US from the US Federal Reserve.

Investment grade credit

It was a month of gently wider credit spreads though little change in the last week.

The Global Index began the month with spreads around 89bps over government bonds and widened by around 4bps. Spreads have traded in a very tight range of around 8bps since the end of Q1,21. The US dollar market underperformed marginally with spreads 4bps wider while euro denominated debt was only a couple of basis points wider in the same period.

It has been a period of strong earnings in general though also characterised by more equity holder friendly behaviour (eg, share buy-backs). Last week was also characterised by a very light period for new issuance, which is normally the case at this time of the year.

High yield credit

US high yield bond prices were modestly lower over the week following a relatively uneventful Fed meeting and heightened concern around the delta variant. The ICE BofA US HY CP Constrained Index returned 0.07% with spreads 10bps wider over the week. According to Lipper, the asset class experienced a $996m inflow over the week. For the month of July, the asset class returned 0.36% and spreads were 27bps wider. Lower-quality issuers underperformed with 0.71%, -0.02% and -0.22% returns for BB, B and CCC-rated issuers, respectively. The month saw approximately $30bn of new issuance, well below the YTD monthly average of $50bn.

European high yield spreads widened 5bps on the week and were 15bps wider for the month of July. Based both on the week and for the month of July, BB outperformed CCC rated credit. The asset class experienced another week of outflows, again solely due to managed accounts as ETFs were quietly in summer mode. The primary market also showed signs of a summer slowdown with another week of only three deals amounting to about €1.7bn. Trading was heavy on the week with Citi saying that it was their strongest trading week since April, with the market tone being quite constructive.

Second quarter earnings have been quite positive with many beating expectations. This has been especially the case for autos with the sector showing a solid set of numbers; this is in spite of a chip shortage, which will likely continue into Q3. Basic industry firms were also showing strong numbers with reports of growth in sales across regions and many being able to pass across price increases. The exceptions have been more downstream industries, such as specialty chemicals that are seeing some squeeze in their attempt to pass on increased costs. In issuer specific news, Cemex numbers were very strong with EBITDA margin at its highest since 2007 and leverage falling. The company is targeting leverage less than 3X and margins greater than 20% by 2023 with the goal of achieving an IG rating.

Leveraged loans

Despite the return of retail fund inflows, leverage loan prices were slightly lower over the week as well. The average price of the J.P. Morgan Leverage Loan index declined $0.15. Yields and spreads (both the 3-year takeout) increased 6bps over the week to 4.8% and +433bps respectively. After experiencing its first outflow in 28 weeks, inflows resumed this week with $298m of subscriptions. For the month, the asset class total return was 0.00% with higher quality issuers outperforming. MTD returns by quality were 0.11%, 0.08% and -0.33%, respectively for BB, B and CCC-rated issuers.

Structured credit

The US Agency MBS market recorded a positive 14bps return, with the sector having a strong week on reduced overall taper expectations. The biggest piece of news, however, was expiration of the eviction moratorium over the weekend. While this may raise considerable concern over heightened foreclosure risk, 14% HPA over the past year should encourage strong reperformance of those in forbearance.

In CMBS, Conduit AAAs have been relatively flat despite strong new issuance volumes while seasoned mezz has rallied on demand from yield buyers. The SASB market experienced no summer lull with the highest monthly BWIC volumes in July since August 2020. Strong demand has kept ABS spreads at / near their tights despite record new issue pace.

Asian credit

Over the last two weeks, there was a step-up in regulatory developments related to the education and consumer internet sector. The General Office of the CPC Central Committee and the General Office of the State Council announced the regulation that will transform the after-school education business (after-school tutoring or AST). Companies that provide AST may be required to be classified as non-profit institutions and foreign ownership is prohibited in academic AST institutions.

On 26 July, the Ministry of Industry, and Information Technology (MIIT) launched a six-month rectification action for the internet industry which will address, among various issues, the disruption in market order, infringement on consumer rights and data security. On the same day, the State Administration for Market Regulation (SAMR) and six other government agencies issued guidelines to protect the rights and interest of food delivery riders, which will likely impact the operating margin of Meituan and Alibaba’s Ele.me. In response to this guideline, Meituan said it will implement the guidance and safeguard the interests and welfare of its riders. The company also said in H1,21, that it has organised riders talks and collected feedback as well as set up a Meituan Rider Service Department.

Emerging markets

China's manufacturing PMI moderated from 50.9 in June to 50.4 in July. Manufacturing activity has been hampered by the rising delta variant cases in China and in key export markets within Asia. On Thursday a drone attack off the coast of Oman on an Israeli linked oil tanker has killed two crew members. The UK and US have blamed Iran and the US have subsequently vowed to respond. This comes as the US announced a 31 August withdrawal date from Afghanistan.

In Mexico Pemex was downgraded to Ba3 by Moody's. Pemex has been struggling to invest in new oil fields and has the highest debt load of any oil company. The Mexican government has pledged further support for Pemex and has been cracking down on private fuel importers giving Pemex the upper hand.

Commodities

Iron ore prices sold off -5.6% last week following China asking steel mills to limit this year's output to no more than 2020's level. Production has already climbed 12% this year, so this implies a contraction is needed for the second half of 2021. Iron ore prices had almost doubled in 2021 on the back of the global manufacturing recovery, particularly within China. Rio Tinto announced its half year results with iron ore accounting for 85% of underlying earnings.

Aluminium prices rallied 3.7% as a result of sluggish production from China. Drought conditions in China's hydroelectric powered aluminium production hub have resulted in smelter curtailments. Elsewhere, coffee prices dropped 5.0% following reports that the Brazilian frost may have been milder than expected.

Responsible investments

In an effort to contain virus breakouts in pigs, companies in China are building double digit story buildings to house pigs. In-house veterinary services as well as carefully prepared meals are on offer to thousands of pigs that are contained in the high-rise buildings. With high security controls in place, companies funding the "hog hotels", such as Muyuan Foods and New Hope Group, are hoping this style of farming will prevent further outbreaks, similar to the African swine fever that wiped out half of China's pigs only a few years ago.

In broader news, sustainability-linked bond issuance increased by 282% in the first half of 2021.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

2nd August 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	▪ 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. ▪ Credit fundamentals across sectors are improving. In fact, some areas see such strong demand turnaround 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	▪ Although spreads have recently widened a touch, the Fed buying has overwhelmed highly negative fundamentals, evidenced 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	▪ Renewed Covid lockdowns