INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

15 NOVEMBER 2021

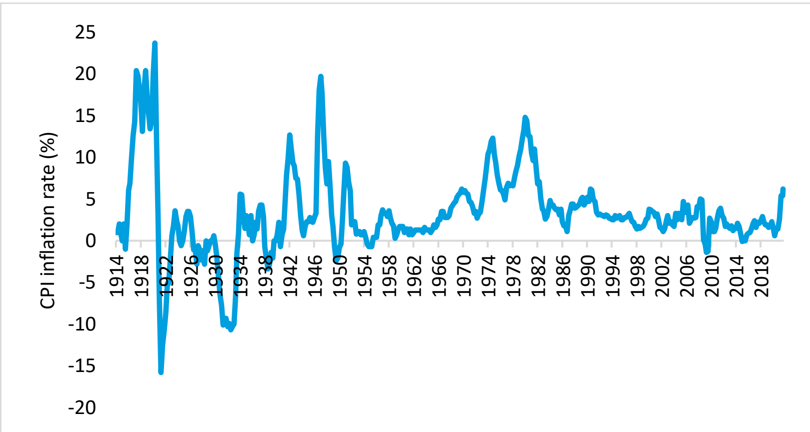
How to dismantle a conglomerate.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	1.55%	10 bps	-0.1%	-2.7%
German Bund 10 year	-0.27%	1 bps	1.1%	-1.7%
UK Gilt 10 year	0.89%	5 bps	0.9%	-4.7%
Japan 10 year	0.07%	1 bps	0.1%	-0.1%
Global Investment Grade	94 bps	1 bps	0.1%	-0.9%
Euro Investment Grade	92 bps	2 bps	0.8%	-0.3%
US Investment Grade	91 bps	1 bps	-0.1%	-1.0%
UK Investment Grade	93 bps	1 bps	0.7%	-2.3%
Asia Investment Grade	192 bps	-7 bps	-0.1%	-0.6%
Euro High Yield	339 bps	-2 bps	0.4%	3.4%
US High Yield	309 bps	-3 bps	0.3%	4.8%
Asia High Yield	833 bps	-66 bps	-0.3%	-12.4%
EM Sovereign	319 bps	-10 bps	0.2%	-1.3%
EM Local	5.6%	-1 bps	0.2%	-7.4%
EM Corporate	302 bps	-10 bps	0.0%	1.0%
Bloomberg Barclays US Munis	1.1%	-2 bps	0.6%	1.1%
Taxable Munis	2.3%	11 bps	0.0%	1.6%
Bloomberg Barclays US MBS	27 bps	1 bps	-0.2%	-1.1%
Bloomberg Commodity Index	218.71	0.1%	-0.5%	31.7%
EUR	1.1449	-1.1%	-1.0%	-6.3%
JPY	113.87	-0.5%	0.1%	-9.3%
GBP	1.3418	-0.6%	-2.0%	-1.9%

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

Chart of the week: US Consumer Price Inflation (1914-2021)



Source: Bloomberg, Columbia Threadneedle Investments, as at 11 November 2021.

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Commodities
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Macro / government bonds

If you are looking for market volatility to spice up your week then core government bond markets would be a good place to start. After last weeks 'communication breakdown' between central banks and investors, and more dovish policy response, that pushed yields sharply lower, an outsized inflation print in the US forced yields into reverse.

Specifically, US consumer prices rose by 0.9% in only one month. That exceeded expectations (0.6%) and took the annual rate of inflation to over 6% **(see chart of the week)**. The last time inflation was this high bond yields and interest rates were around 8%, not 1.6%. We better hope inflation proves to be indeed transitory.

The market climate was also troubled by rising tensions between Russia and neighbour Ukraine with indications of a massing of troops on the border that separates the two countries. Meanwhile, in response to other border tensions, Belarus President Lukashenko appears to be threatening to disrupt gas supplies to Europe. If this wasn't enough, there are signs of rising Covid cases globally; with Germany being a good example.

In the UK, a weaker Q3 GDP report means the economy is still around 0.6% lower than was the case pre-pandemic, while the UK is currently facing broad-based shortages of labour.

Investment grade credit

Last week spreads were wider – not by a lot - but wider, nonetheless. This comes at a time when new issuance has started to pick up after the earnings related, seasonal lull.

In issuer specific news, General Electric (once the largest company in the world) has announced it intends to break itself into three separate companies. These will focus on healthcare, energy and aviation respectively. The company has been on a debt reduction path (eg, the sale of its aircraft leasing business) for a few years now, with bond spreads tightening accordingly. The company's split seems seems to have started a wider trend; another large conglomerate (Toshiba in Japan) has announced plans to do likewise and will also split into three businesses.

High yield credit

US high yield bond spreads tightened modestly over the past week amid a sharp upward move in US treasury yields, leaving prices lower. The ICE BofA US HY CP Constrained Index fell -0.25% and spreads were 3bps tighter. According to Lipper, the asset class reported a $2.6bn inflow, making it the third weekly inflow over the last four weeks.

European high yield had a flat week, performance wise, even as spreads tightened in a couple of basis points to 339bps and single Bs posted a positive performance, outperforming negative performers BBs and CCCS. The primary market was lighter than the previous weeks, despite a €1.5bn new issue from Lufthansa. Lufthansa is proving to be a great transitioning story having moved from being a Fallen Angel which had to resort to German government state support in 2020 to moving into a strong fundamental story with healthy yields and positive market tailwinds, in the cargo space given current shipping logistic issues. Flows into the asset class were positive for the week, solely supported by inflows into ETFs as managed accounts experienced outflows.

Given the strong gross issuance seen in 2021 so far, and expected for the calendar year, talk is already that that it will moderate in 2022. The statistics for 2021 have gross issuance at around €150bn year-to-date, of which 50% has been refinancings. This shows a good amount of new high yield entries when you remember that 2016 gross issuance was 100% of refinancings.

In credit rating news, the upgrade/downgrade ratio has moved into positive territory with higher amount of upgrades happening. However, to put this in context, at the current run rate of rating upgrades, it is calculated that it will still take three to four years for the market to return to the rating quality of 2019.

Leveraged loans

The average price of the J.P. Morgan Leveraged Loan index rose $0.08 this week to a new year-to-date high despite a sharp increase in rates. Inflows to the asset class increased over the week to $968m, making it the largest weekly inflow since April.

Structured credit

The US Agency MBS market was down 61bps last week in sympathy with other duration-sensitive assets as rates sold off. The market's reaction to the Fed's taper continues to have minimal effect on spreads, which remain historically tight. 15-year mortgages have traded relatively stronger than 30 years on heightened bank demand. In the non-agency sector, affordability is waning, and new supply has weighed more recently on spreads. Spreads are now anywhere from 10-50bps wider versus the summer months. CMBS continues to see improved metrics with rent collection in retail properties at 90+% versus pre-covid levels. September and October were the busiest months in new issuance since 2019, evidencing strong investor demand. In the CLO market, managers are pushing to close deals in Q4 ahead of the SOFR transition, which has resulted in increased supply. Demand for the more senior tranches has offset that supply while Mezz bonds have traded a bit wider. With 12-month trailing defaults at 10-year lows, fundamentals in the loan market remain solid.

Emerging markets

In China, deeply discounted property names saw some relief as a state-backed newspaper indicated the authorities were likely to loosen lending controls, allowing real estate companies to issue local currency debt. Sunac, China's 4th largest property company, raised $953m in cash via the sale of new shares and property divestitures. China also released its 12 month CPI and PPI figures for October, which rose 1.5% and 13.5% respectively.

On the geopolitical front, an estimated 90,000 Russian troops are massing on the Ukrainian border. The US fears an invasion of Ukraine and is conducting naval drills on the Black Sea as a show of force. Elsewhere, refugees at the Polish/Belarus border are attempting to gain access to Europe but are sandwiched between Polish and Belarusian troops. The EU is threatening sanctions against Belarus for pushing migrants towards the border and Belarusian President Lukashenko threated to cut off the Yamal Europe gas pipeline in retaliation.

Commodities

WTI moderated -0.5% as the market mulls over the prospect of either a US strategic petroleum reserve (SPR) release or a crude export ban. President Biden has been vocal about energy prices being too high and has attempted to pressure OPEC into more aggressive production hikes.

Natural gas was the biggest loser of the week down -13.2%. The decline was driven by increased supply from Russia, which has been restricting supply and, in some cases, reversing pipeline flows into Germany. Russia previously promised to alleviate Europe's gas shortage; however, it also seeks a speedy final approval of its Nord Stream 2 pipeline.

Wheat prices rallied 6.4%, taking prices to the highest level since 2012. The crop was hit by droughts, frosts and heavy rains, along with the USDA recently scaling down its wheat stock projection. Russia, a top wheat exporter, recently doubled its taxes on exports to $80 a tonne. Unlike other animal feed-focused agricultural commodities, wheat-based products feed directly into inflationary baskets.

Responsible investments

After a lengthy two-week summit, the COP26 meeting is complete. The Glasgow Climate Pact has been written and agreed to by almost 200 countries. The standout result is that in one year, countries have been asked to come back to the table with upgraded pledges in line with the 1.5 degrees target. After that, a five-year review cycle will resume. This should hopefully keep up the momentum for countries to continue making changes and progress towards their goals.

It wasn't all plain sailing, as a last-minute revision of the text caused quite the commotion. China suggested changing the language on the reduction of coal from 'phase-out' to 'phase-down', a turn of phrase used in a bilateral agreement between China and the US earlier in the week. It was left to India's environment minister to spell out the change of phrase. It was too late for other nations to open up the text and led to some nations immediately complaining that this was a far softer tone to a reduction in coal power.

Keep an eye on our website for a post-COP26 summary thought piece from our Responsible Investment team.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

15th November 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 £ €	▪ Yields have broken out of their earlier tight ranges but likely to remain capped by structural downtrend in real yields and growth ▪ 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	▪ Inflation becomes more persistently entrenched, warranting much higher rate structure ▪ 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$ $	▪ The US leads the way on the economic recovery from the pandemic, which drives a monetary wedge between the Federal Reserve and ECB ▪ Window for dollar underperformance has narrowed as central banks globally turn more hawkish on inflation expectations at the expense of growth	▪ Re-acceleration of global growth forecasts led by reversal of China credit contraction ▪ 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 ▪ 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 ▪ Tightening global financing conditions
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 Soybeans ▪ o/w Oil	▪ US China trade war ▪ Renewed Covid lockdowns ▪ Global Recession

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