COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

19 OCTOBER 2020

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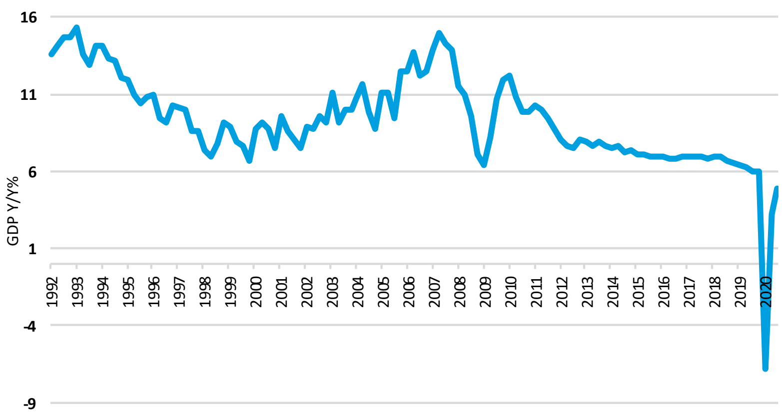
(Un)broken China.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.77%	0 bps	-0.4%	8.8%
German Bund 10 year	-0.61%	-9 bps	0.9%	3.5%
UK Gilt 10 year	0.20%	-8 bps	0.6%	8.8%
Japan 10 year	0.03%	-1 bps	0.0%	-0.8%
Global Investment Grade	129 bps	-1 bps	0.6%	5.6%
Euro Investment Grade	112 bps	1 bps	0.9%	1.6%
US Investment Grade	133 bps	-2 bps	0.5%	7.2%
UK Investment Grade	124 bps	0 bps	0.7%	5.3%
Asia Investment Grade	252 bps	0 bps	0.2%	5.3%
Euro High Yield	475 bps	9 bps	1.0%	-1.6%
US High Yield	494 bps	2 bps	1.4%	1.1%
Asia High Yield	695 bps	23 bps	-0.1%	2.1%
EM Sovereign	377 bps	3 bps	1.5%	1.9%
EM Local	4.5%	-1 bps	1.0%	-5.4%
EM Corporate	390 bps	2 bps	0.8%	3.4%
Bloomberg Barclays US Munis	1.4%	-2 bps	-0.3%	3.0%
Taxable Munis	2.3%	-4 bps	-0.8%	9.2%
Bloomberg Barclays US MBS	58 bps	2 bps	0.0%	3.6%
Bloomberg Commodity Index	157.61	0.2%	3.6%	-8.9%
EUR	1.1785	-0.9%	0.0%	4.5%
JPY	105.32	0.2%	0.1%	3.1%
GBP	1.3005	-0.9%	0.0%	-2.6%

Source: Bloomberg, Merrill Lynch, as at 17 October 2020.

Chart of the week: China GDP growth (y/y%) 1992-2020



Source: Bloomberg and Columbia Threadneedle Investments, as at 19 October 2020.

Macro / government bonds

Core government bond yields were little changed last week. As we keep writing, the benchmark 10- year US treasury note has spent most of the last six months in a very tight range (0.6-0.8%).

Supporting bond prices is the increasingly alarming spread of Covid-19 in Europe and the US and the expected effect this will have on economic activity. There was also a weak US jobs report that suggested the improvement in the labour market has drawn to a halt. US retail sales, however, were stronger at +5.4% yoy. Meanwhile, the increasing likelihood that Joe Biden wins the US election on 3 November and that the Democratic party takes the US senate exerts an equal and opposite effect on the market. It is presumed that this outcome would lead to higher spending and fiscal support for the US economy.

In other news, ratings agency Moody's reduced the UK's credit rating by one notch to Aa3, citing weakening growth and a deteriorating fiscal position as reasons for the move. There appears little progress between the UK and Europe with regard to a Brexit agreement although talks remain ongoing with a mid-November deadline for reaching an agreement.

Europe announced further lockdown measures (eg, Italy, France and Ireland). It appears there will be further easing measures coming from the ECB given reduced inflation expectations.

Investment grade credit

Investment grade spreads have gently tightened since the end of September. The Global index is now around 7% tighter since the end of the quarter though over 35% wider for the year-t- date. The US market has outperformed marginally so far in October.

US banks reported Q3 results, which suggested businesses continue to do well, that margins are under pressure and the consumer sector remains in a relatively healthy state.

New issuance remains light given we are in reporting season.

High yield credit

US high yield bond prices were effectively unchanged over the week despite the lack of stimulus bill progress, weak labour market data and increased attention on rising Covid-19 rates. The ICE BofA US HY CP Constrained index returned 0.06% and spreads were 2bps wider. Primary market activity has slowed following back-to-back $50 billion+ volume months in August and September. High-yield issuance totalled $5.5 billion over the week; thus, October's new issue volume totals $16.5 billion, down from September's pace which produced $50.9 billion of new issuance. Inflow momentum also continued following the sharp outflows in late September. The asset class experienced a $2.2 billion inflow, leaving the two-week total at $6.2 billion.

European high yield gave back last week as spreads widened 9bps even as flows continued into the asset class with €212 million into both ETFs and managed funds. Though selling was due to some increase in risk aversion on the back of the upcoming US elections, progress on Brexit and the rise of the second Covid-19 wave, it was also driven by investors making room for new issues as there remains strong interest in higher quality risk. BBs outperformed Bs and CCCs last week. Primary market was busy with €7 billion of debt issued, the largest amount in the last five weeks. Issuer names included INWIT (Italian telecom); Rolls Royce ($2 billion bond offering, €, £, and $); TEREOS (French sugar producer); Cellnex (Spanish telecoms); CMA (shipping containers); CANPACK (packaging); Veolia hybrids; and Peach Property (German real estate group).

In issuer specific news, Bertelsmann, the German media company was downgraded by S&P, bringing the firm's hybrids into the high yield space. Ford announced it will have to recall its hybrid car in Europe due to the risk of the charging unit catching alight. That means Ford will not meet the requirements for emissions standards in 2020. Continuing in the auto sector, European car sales were up 1.1% with Italy and Germany outperforming, while French car sales weakened given the expiration of the government incentives. On the other side of the globe, car sales in China and US are showing more resilience. There is concern, however, that US sales may falter depending on the results of the US presidential election and whether the latest stimulus package materialises.

US leveraged loans

Leveraged loan prices were also largely unchanged over the past week alongside mixed price action across broader markets with prices recovering a net +$0.39 since 9/25 after falling -$0.79 between 16-25 September. Meanwhile, loan yields and spreads (3-year) increased 2bps apiece over the past week to 5.88% and 562bps, which compare to as low as 5.69% and 545bps on 9 September. The leveraged Loan index is providing a +0.51% gain in October following its +0.63% gain in September with B loans (+0.60%) outperforming Split B/CCC loans (+0.33%) and BB loans (+0.23%). The asset class experienced a rare inflow, largely ETF driven, with $181 million entering the asset class over the week. This was only the seventh inflow for leveraged loans over the last 98 weeks and the largest since January 2020.

Structured credit

US Agency RMBS was flat on the week as rates bear flattened on rising Covid-related lockdowns and vaccine-related disappointments. Originations were heavy and demand a bit light. Spreads were marginally wider for all but the lowest coupon mortgages. Forebearance news continued to lean positive. In GNMAs, roughly half of the mortgage universe in forebearance expired in September. Of those borrowers, 25% of borrowers who were current on their mortgage and 22% of technically delinquent borrowers exited and did not seek extensions. Of those that did extend, the majority favoured a 3-month versus a 6-month extension. In CMBS, spreads grinded tighter over the week on favourable customer demand.

Emerging markets

Emerging markets gave back last week as spreads widened, albeit marginally, for both hard currency sovereign and corporate bonds as higher beta names came under pressure. Local debt also was down, due to FX movements. Still the asset class experienced large inflows of $1.9 billion into both hard and local currency funds. That's now 14 weeks of straight inflows.

There were more downgrades as S&P became the first rating agency to lower Oman's rating from BB- to B+. This is a by-product of oil prices and the country's rising debt to GDP. Chile saw its Fitch rating moved from A to A- but with the outlook moved to stable. Fitch said the change was due to deteriorating public finances from increased social spending, post the protests in late 2019, which had been compounded by the pandemic effects. Another country default in the wings is Zambia, which has missed a coupon payment. The government is trying to get major bondholders to accept a debt restructuring but one large investor is refusing to consider this.

In country specific news, more hard news from Argentina as international reserves were seen to fall by more than $250 million last week. In Thailand, political tensions are rising and rising fast; a state of emergency has been declared and protest leaders arrested. Still, there was good news from China as retail sales and industrial production continue to rebound. China's Q3 GDP came in at 4.9% (see **chart of the week**).

In other news, G20 debt relief has been extended to mid-2021. This further extends the debt relief waiver for the world's poorest 77 countries that was made earlier in April due to Covid19. At the same time, there is now talk of sovereigns may start to seek private credit relief.

Asian fixed income

AAC Optics, a subsidiary of AAC Technologies, has received additional investments of CNY1.66 billion from 18 new investors. In July 2020, the subsidiary had received CNY1.15 billion of investments from four investors (Xiaomi Corp, Oppo, Shenzhen Huiyou and Nanjing Huarui). With this latest transaction, AAC Technologies will hold an 82% stake in AAC Optics.

Lenovo Group has received the first-time Baa3 and BBB- ratings from all three rating agencies. Both Moody's and S&P rate Lenovo with a stable outlook while Fitch assigns a positive outlook. According to Moody's, Lenovo's Baa3 rating is driven by the company's position as the leading personal computer provider with strong brand recognition and geographical diversity.

S&P cut PT Modernland Realty Tbk (Indonesia property developer) to "D" because the company is unlikely to cure the coupon payment default on its $240 million MDLNIJ '24s within the 30-day grace period. S&P expects the company to initiate a debt restructuring for its two-tranche senior unsecured notes – MDLNIJ '21s ($150 million) and MDLNIJ '24s ($240 million). Alam Sutera Realty has obtained 74.4% consent on the exchange offer for its $115 million bond, due 2021 and it also secured 86.4% consent on the exchange offer for its $370 million bond, due 2022. The rating agencies view the transactions as distressed exchanges due to the significant economic loss for bondholders.

Commodities

Crude fell by 1.0% over the week. Natural gas rallied by 2.3% . The IEA's new baseline scenario for energy consumption assumes a return to pre-crisis demand levels in early 2023. In the 'delayed recovery scenario' demand doesn't recover until 2025. Due to the decline, some refineries are expected to close permanently. In response to increased coronavirus restrictions, OPEC is reconsidering removing production cuts, given the increased likelihood that the expected pick-up in crude oil demand will not materialise.

Wheat reached a 6-year high and was up 5.3% on the week. This was driven by dry conditions in key US growing states, such as Kansas and crop concerns in the Black Sea regions. Pakistan and China have also been stepping up their wheat imports. There was also a 4% rally in corn and 3.7% in cotton. Collahuasi, one of Chile's largest copper mines, succeeded in averting strikes following union agreements with the mine's operators. A strike is also planned at Candelaria; while this mine is smaller, it underscores supply risks in the world's largest copper producer. Copper was up 0.7% on the week. In precious metals, silver extended gains rallying 1.3% on the week whilst gold was close to flat.

Responsible investments

The European Commission announced it will issue €100 billion as social bonds, or EU SURE bonds. This is the largest social bond issuance from a single entity in history, and will support people in EU member states to protect jobs and reduce the social impact of the pandemic.

The Pope is now able to showcase his greener side as his fully hydrogen-powered popemobile was delivered from Toyota last week, a gift from the Catholic Bishops' Conference of Japan. The 'Mirai' produces zero-emissions and has the signature viewing platform that allows the Pope to stand and be seen by passers-by.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

19th October 2020

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 spread tightening of the last 5 months leaves valuations much closer to long-term averages, and a more modest overweight to credit risk is warranted. There are still enough attractive opportunities to build a portfolio that is overweight credit risk, although some sectors are offer little upside. ▪ Technicals are positive across the board. The Fed's new strategy underlines lower for longer and targeting easy financial conditions. The demand for credit products remains high. ▪ Fundamentals continue improving, even if slower than in the summer. Vaccine progress is coming steadily.	▪ The Feb garbles its messaging in how it will carry out its new policy framework ▪ Cooler weather leads to virus acceleration and school closures hamper labour productivity. ▪ The damage done to the labour market is deep & long-lasting. ▪ Vaccine development slows.
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long € £	▪ Recovery pace to slow as government support wanes, consumption rebound fades ▪ Reflation credibility still low, despite Fed framework review ▪ Fed QE and high personal savings underpin demand for treasuries ▪ ECB readying new stimulus effort ▪ Duration remains best hedge for further risk asset correction	▪ Unexpected medical advance allowing full, rapid economic re-opening ▪ Permanent fiscal policy shift rebuilds reflationary credibility ▪ Fiscal largesse steepens curves on issuance expectations ▪ Risk hedge properties deteriorate
Currency ('E' = European Economic Area)	£ E EM Short -2 -1 0 +1 +2 Long A$ ¥ $	▪ Recent USD weakness has come as a result of relatively worse interest rate, Covid and fiscal dynamics. This is now largely priced and we expect a pause in the downtrend. ▪ Longer term, expensive valuations and twin deficits presage a weaker Dollar	▪ A second Trump term could lead to USD strength through more aggressive trade policy ▪ Reimposition of Covid restrictions in Europe
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	▪ Many EMs lack the policy space to offset demand destruction ▪ Currencies the likely pressure valve as central banks finance fiscal deficits ▪ EM real interest rates relatively attractive	▪ Further 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	▪ The stable/weaker USD over the last 4 months has eased fundamental and technical pain. ▪ EM IG has tightened inside long-term averages versus US IG, but EM BB/B remains attractive versus US BB/B. ▪ The peak in defaults and restructurings has passed and the landscape of EM is relatively stable. ▪ The wave of global liquidity is reaching EM, but after it ran through developed market credit.	▪ The USD strengthens. ▪ 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 valuations were the most directly affected by the Fed and normalized most quickly. Valuations are now at long-term medians, but the index duration is 30% longer. ▪ Fundamentals have been more positive than expected. Leverage has risen, but so too has cash. ▪ With Treasury yields likely very low for an extended period of time, technicals favour IG as a safe asset substitute.	▪ The Fed does not renew its Corporate Credit Facilities. ▪ Foreign buyer flow stops for geopolitical, financial, or regulatory reasons. ▪ The cash stockpiles taken out at the depths of the crisis are deployed on large-scale M&A instead of deleveraging.
High Yield Credit	Under-weight -2 -1 ■0 +1 +2 Over-weight	▪ Spreads & new issue supply underline that companies with sounds economics have no issue accessing financing. Valuations are mostly back in line with long-term ranges and are moderately attractive versus IG, but less compelling than earlier in the recovery. ▪ The ability to access financing has dramatically improved the prospects for many companies, and the impact of COVID on companies with bonds >$80 is manageable.	▪ Prolonged COVID-19 related slump in activity would hurt these companies most. ▪ The sector most sensitive to changing financial conditions.
Agency MBS	Under-weight -2 -1 ■0 +1 +2 Over-weight	▪ The Fed's QE including Agency MBS has been a significant tailwind for a sector with worse fundamentals. ▪ But valuations are much more neutral now, although the Fed's quantity of buying is overwhelming the market. ▪ Forbearances have been better than expected, and are still relatively low (including GNMA, which has been hit hardest).	▪ Fed reallocating MBS purchases towards Treasuries. ▪ Bonds will underperform other spread product in a sharp risk-on move. ▪ Renewed interest rate or curve volatility.
Non-Agency MBS & CMBS	Under-weight -2 -1 0 ■+1 +2 Over-weight	▪ Non-Agency MBS: fundamentals have held up better than expected into this crisis, and the housing market is the strongest sector in the economy thanks to low interest rates and desire for more space for continued WFH. CMBS: Retail tenant payments & hotel occupancy are improving. Office is still struggling but valuations reflect this. ▪ Valuations vary wildly, but are broadly attractive. Given performance, trimming some riskier positions & doubling down on conviction credit is due.	▪ 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 ▪ u/w Crude, u/w natural gas ▪ o/w Soybeans vs Corn ▪ o/w refining margins (o/w products, u/w Brent)	▪ Oil production disruption