COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

14 DECEMBER 2020

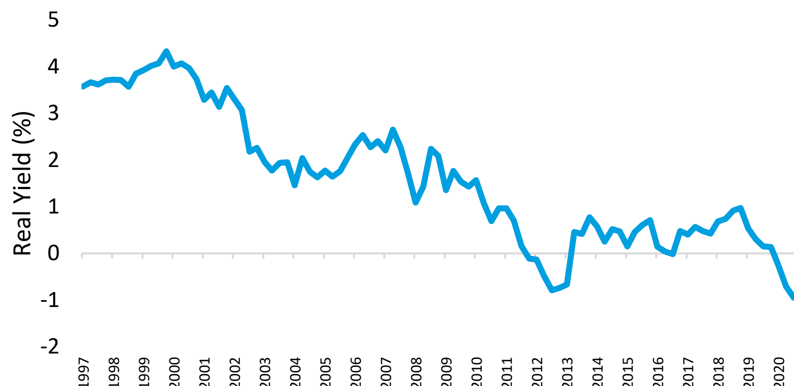
The (end of the) year of living dangerously

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.88%	-8 bps	-0.2%	8.3%
German Bund 10 year	-0.64%	-9 bps	0.5%	3.6%
UK Gilt 10 year	0.17%	-18 bps	2.1%	9.3%
Japan 10 year	0.01%	-1 bps	0.2%	-0.6%
Global Investment Grade	108 bps	3 bps	0.1%	7.3%
Euro Investment Grade	93 bps	1 bps	0.4%	2.9%
US Investment Grade	111 bps	4 bps	-0.1%	9.1%
UK Investment Grade	99 bps	-1 bps	1.4%	7.9%
Asia Investment Grade	237 bps	0 bps	0.2%	6.2%
Euro High Yield	366 bps	4 bps	0.6%	2.6%
US High Yield	408 bps	5 bps	0.9%	5.2%
Asia High Yield	615 bps	-8 bps	1.2%	5.9%
EM Sovereign	339 bps	7 bps	0.8%	4.8%
EM Local	4.3%	-1 bps	2.5%	1.7%
EM Corporate	335 bps	-1 bps	0.9%	6.5%
Bloomberg Barclays US Munis	1.1%	-4 bps	0.4%	5.0%
Taxable Munis	2.2%	-9 bps	1.0%	11.6%
Bloomberg Barclays US MBS	48 bps	3 bps	-0.1%	3.6%
Bloomberg Commodity Index	159.92	0.8%	0.7%	-7.1%
EUR	1.2125	-0.1%	1.6%	8.0%
JPY	103.87	0.2%	0.3%	4.5%
GBP	1.3230	-1.6%	-0.7%	-0.2%

Source: Bloomberg, Merrill Lynch, as at 14 December 2020.

Chart of the week: 10-year US Real Yields (1996-2020)



Source: Bloomberg and Columbia Threadneedle Investments, as at 14th December 2020.

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Season's Greetings

The **IN CREDIT** team wish you the compliments of the season and a very happy New Year. This is the last **IN CREDIT** of 2020. The next publication will be on 4 January 2021.

Macro/government bonds

For 2021 the background for government bonds remain relatively supportive.

Low levels of growth and the persistent absence of inflation mean that policy rates will remain under downward pressure and the twin political challenges of finding a fiscal package in the US and avoiding a no-deal Brexit in the UK/eurozone means a normalisation of yields is not our central forecast. Indeed, in general our Macro funds reflect a positive duration bias.

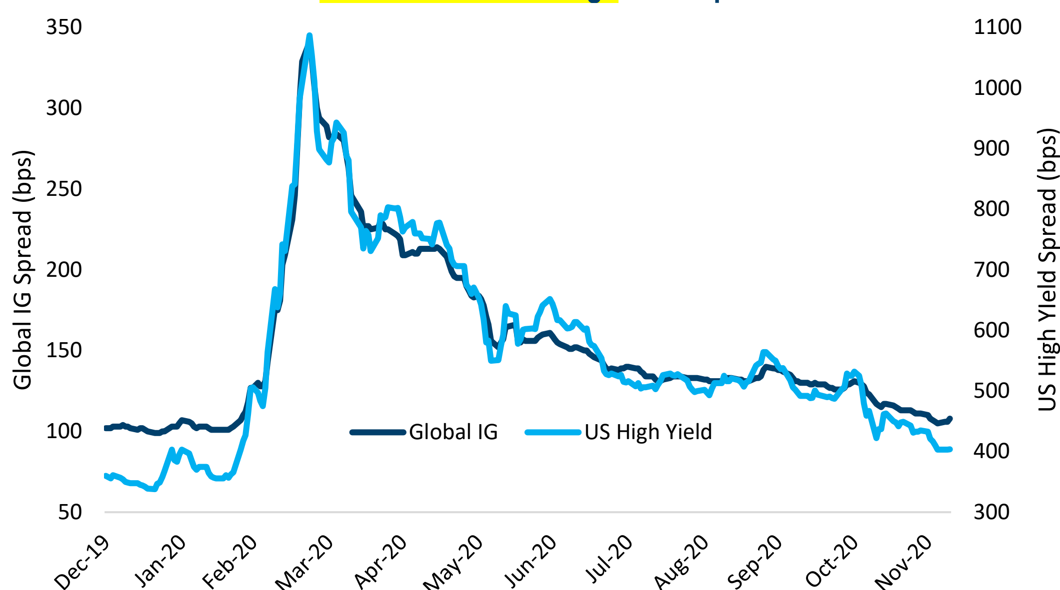
It is hard to suggest there is a lot of value though. Indeed, we end the year with the lowest US real yields since the introduction of inflation linked notes in 1996. Real yields are what an investor receives from US government bonds after compensating for inflation. As can be seen in the **Chart of the Week**, they are beyond low and are actually deep in negative territory.

Last week brought more bad case news about Covid-19, but also the start of vaccination in the UK and the passing of the Pfizer/BioNTech product for emergency use in the US. In economic news, UK GDP for October came in at +0.4%, which took the three-month-on-three-month annual rate to 10.2% from 15.5% in September. However, in the US jobless claims surged higher. In Europe, the ECB did as expected and kept rates unchanged while increasing the PEPP programme of bond-buying by €500 billion to €1.85 trillion, and extending buying by nine months until March 2022. The TLTRO III programme was extended until mid-2022.

Investment Grade credit

This last year has also been a see-saw period for credit spreads. The **Second chart of the week** shows that Global IG spreads are very close to where they started the year having been as high as 340bps in early spring, while their High Yield cousins have followed the same trajectory – though remain somewhat above the levels of early January.

Second chart of the week – Global IG and USD High Yield Spreads in 2020



Source: Based on BofA Merrill Lynch Bond Indices. Bloomberg and Columbia Threadneedle Investments, as at 14 December 2020.

As we recall the chaos of mid-March from the relative calm of late December, it is with some degree of optimism that we look forward to 2021. Credit markets will remain supported by ultra-loose monetary policy conditions for the foreseeable future, in all areas of developed markets. Meanwhile, we have more optimism about economic growth than was the case earlier this year, driven in large part by policy support and the introduction of efficacious vaccines. Indeed, we expect pre-pandemic levels of GDP to be achieved by late 2021/early 2022

Credit fundamentals also appear to be more supportive with the expectation of profit growth and increased cash flows being directed towards deleverage. Likewise we expect to see lower levels of new issuance in the next 12 months than the prior year.

Where our enthusiasm is somewhat tempered is when we look at valuations. We began 2020 with spreads globally around half a standard deviation expensive to longer-term averages. The spring sell-off took these spreads to the most attractive levels since the global financial crisis (See Second chart of the week). As we end the year we are back to where we started – though note that much of the time, spreads tend to drift along below the long-term average before periods of crisis and illiquidity push them wider.

High Yield credit

US high yield bond returns were modestly positive over the week as expectations for ongoing monetary and fiscal support matched with a cyclical recovery in 2021 continue to boost risk appetite. The ICE BofA US HY CP Constrained index returned 0.05% and spreads were 10bps tighter. The primary market remained robust with 18 bonds pricing for a $10.2 billion total, which is notable in the context of average monthly issuance for the month of December of $16 billion over the last 10 years. According to Lipper, asset class flows were effectively $0 for the week.

The rise in leveraged loan prices also extended over the past week amid continued risk-on tone. The average price of the J.P. Morgan Leveraged Loan index increased +$0.32 to $96.79 over the past week with the average price for BB loans increasing $0.25 to $98.56; Single B loans increasing $0.35 to $98.27; and Split B/CCC increasing $0.38 to $85.73. Loan yields and spreads (three-year) decreased 12bps and 10bps over the past week to 5.22% and 496bps. This is the lowest yield for the loan index since August 2014, although spreads of 496bps compare with as low as 441bps on 21 January 2020. The asset class experienced its ninth inflow over the past 106 weeks with a $117 million inflow as 10-year US Treasury yields approach 1%.

The European High Yield market paused last week, after the strong rally in November, as spreads widened 10 bps to 372 bps. Inflows, however, picked up with €335 million coming into the asset class, largely via ETFs but also into managed funds.

For the primary market it was an even stronger week than the previous one, with €4.6 billion of issuance taking the year's total to €102.4 billion. This break's the previous year-high issuance in 2017 of $101 billion. Corporates who came to the market last week included IMA (Italian-based packing machine manufacturer) for €830 million; Ford for £750 million; Ziggo (Dutch cable and satellite) for €700 million; and Counter Global (UK power generation) for €710 million.

In M&A news, Repsol announced that it was selling a 25% stake in its client business which has a €2.5 billion valuation. Repsol will still retain control. In a ditched deal, SBB (the Swedish property

firm) pulled out of a $3.4 billion acquisition when a new bond deal (€1.2 billion) was launched. However, the bonds didn't appear to react the news. The target company put out a press release denying the reasons given (a question whether the evaluation supported the acquisition price). In other news, the Atlantia/Autostrade story continues to drag on as CDP looks to propose a new offer with the deadline now extended into the new year. While Apollo, the asset management group, made public its purchase of IGT's non-lottery gaming business (Lottomatica) for €950 million.

In credit rating news, Moody's unexpectedly downgraded Telecom Italia to Ba2 citing concerns regarding the "aggressive" financial policy decisions. Novomatic saw its rating cut to BB from BB+ Neg, with S&P citing the Covid-19 impact on performance which has kept leverage above BB+ levels as well as the ongoing legal proceedings in Austria.

Trading volumes have started to subside as we move into the Christmas season, already registering at 50% of the previous week's. Technicals continue to remain supportive for the asset class.

US leveraged Loans

The US Agency MBS market was marginally positive last week on slightly lower rates and a flat curve. Mortgage rates remain sticky despite daily/weekly changes, while fast prepayment speeds remain a headwind. The consensus view is that Fed involvement will persist into the new year. The housing market remains a bright spot which is supportive on Non-Agency RMBS. Limited supply coupled with pent-up demand and strong affordability all bodes well for continued strength in home price appreciation. Roughly 5.5% of mortgage borrowers remain past due on payments through forbearance or delinquency, which is down from 7.4% in August. In ABS, consumer performance continues to exceed expectations. AAA spreads are near pre-Covid tights but bonds deeper in the cap structure remain wider. In CMBS, fundamental performance is mixed but generally improving. In that sector, forbearance is roughly 7.5% with industrial and multi-family performing best and hospitality reliant on business demand together with lower quality retail performing worst.

Emerging markets

Emerging markets also took a pause last week, even as inflows into the asset class remained strong and rising. Inflows reached €2.9 billion, going almost equally into both hard and local currency funds.

In central bank news, Brazil, Peru and Chile, as expected, kept rates unchanged at 2%, 0.25% and 0.5% respectively. In Colombia, an IMF official, Villar, was named the new central bank governor. On the credit rating front, S&P joined other agencies in downgrading Sri Lanka to CCC+ (from B-), citing the country's worsening fiscal position as well as concerns regarding its ability to service its outstanding debt.

In country news, there was heightened risk for Turkey as the US said it would impose sanctions on the country for its purchase of a Russian missile system. At the same time, the EU said it would expand the travel ban list for Turkish citizens connected to controversial energy exploration in the eastern Mediterranean.

JP. Morgan released its client survey this week which shows that investors have EM FX

exposure at the highest level for this year, with hard currency EM exposure also remaining at an all time high.

Commodities

The commodity index was up 0.8% over the week. Key drivers include the anticipated approval of the Pfizer vaccine in the US, the US stimulus package, an upcoming OPEC meeting this week, and the overall broad dollar weakness.

Crude rallied by 2% following a second tanker explosion in Saudi Arabia, bringing geopolitical risk back to the forefront. Oil markets have also benefitted from OPEC's decision to ease output cuts more gradually than expected. Looking forward, Iran is planning to almost double production in anticipation of President-elect Biden's softer stance towards Tehran.

Base metals were up a marginal 0.8% following strong performances over the previous weeks. In precious metals, gold was flat and silver fell -0.5% on the week. In agriculture, the index was up 1.3%. Wheat was the star performer, rallying 5.5%. This was driven by both expectations of strong demand for US supplies and a Russian proposed $30 export tax on the grain from mid-February 2021 to the end of June to help control domestic wheat prices. US wheat futures closed just below $617 on Friday.

Responsible Investments

Canadian prime minister Justin Trudeau has increased the country's carbon tax and will be spending $12 billion in new money to help fight climate change and hit Canada's carbon emissions target by 2030.

As the world's largest carbon emitter and energy consumer, China has promised to be carbon neutral by 2060 and have its carbon footprint reduced by at least 65% of 2005 levels by 2030. Along with numerous other pledges, this commitment was announced at the virtual Climate Ambition Summit on Saturday by President Xi Jinping. He said, "The coronavirus pandemic has led us to reflect on our relationship with nature and increased our attention on the future of climate management". These small steps have been seen as unambitious, albeit in the right direction.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

11th December 2020

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	■ An economic recovery continues, potential COVID vaccines are on the horizon, and broad policy support still exists. This is broadly a positive outlook for risk assets. ■ Despite this outlook, prices matter. Valuations are no longer attractive enough to justify risk-taking solely by themselves. Most sectors are back to their normal spread range. ■ Several of the tail risks of the last several months have been removed, notably the US election and w orries a potential vaccine w ould underw helm.	■ The 'bridge' of policy support ends before getting to the other side of the fundamental economic slow down. ■ The virus outbreak becomes completely untenable to maintain commerce functioning. ■ Hiring grinds back to a halt w hile unemployment remains elevated ■ Vaccine development slow s.
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long £ €	■ Renew ed virus concerns and economic disruption to keep nominal grow th subdued ■ Reflation credibility still low , despite Fed framew ork review ■ Fed QE and high personal savings underpin demand for treasuries ■ ECB readying new stimulus effort, while supply declines ■ Duration remains best hedge for further risk asset correction	■ Vaccine development pace exceeds expectations, permitting rapid normalisation ■ 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$ $	■ A Biden presidency should see a w eaker dollar through the reduction of trade w ar risk premium. ■ Longer term, expensive valuations and tw in deficits presage a w eaker Dollar	■ Fiscal gridlock continues in the US, w hich undermines grow th and risk sentiment ■ Extension of Covid restrictions in Europe and accommodative ECB policy
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ Favourable advanced economy setting support EM assets near term ■ EM real interest rates relatively attractive, curves steep	■ 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	■ Tail risks that w ould acutely affect EM have passed. Exposure to goods/commodities production and China have been positives as w ell. ■ EM IG has tightened inside long-term averages versus US IG, but EM BB/B remains attractive versus US BB/B. ■ EM has lagged US credit and technical have been improving for EM. ■ The w ave of global liquidity is reaching EM, but after it ran through developed market credit.	■ The USD strengthens. ■ Grow th scars from COVID persist and hurt commodity prices & ability to grow out of deficits. ■ Governments show little w illingness to address deficits post-COVID.
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	■ IG companies continue to adapt w ell to the economic environment, given that they are the best-in-class operators in their industries. ■ Robust ability to issue debt and equity to build cash reserves has added a lot of margin of error, as has better-than-expected improvement in many industries (especially outside of services) ■ Spreads are near average. This is offset on one hand by longer index duration & on the other by policy support.	■ 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 are modestly inside LT averages, even adjusting for the better quality of today's index. ■ The ability to access financing has dramatically improves the prospects for many companies, especially for COVID-affected industries. ■ Given the w eaker balance sheets and the exposure to COVID-hit sectors, the positive vaccine new s is an appreciated support for fundamentals	■ Prolonged COVID-19 related slump in activity w ould hurt these companies most. ■ The sector most sensitive to changing financial conditions. ■ The combination of policy support, vaccine, positive technical, and economic recovery takes spreads w ell-inside averages
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ The Fed's QE including Agency MBS has been a significant tailw ind for a sector w ith worse fundamentals. ■ Rapid housing recovery and increase in sales is leading to high repayment speeds, negatively affecting the sector. ■ But valuations are much more neutral now , although the Fed's quantity of buying is overw helming the market.	■ Fed reallocating MBS purchases towards Treasuries. ■ Bonds w ill underperform other spread product in a sharp risk-on move. ■ Renew ed interest rate or curve volatility.
Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ RMBS: Housing has been a major outperformer in this recovery, as demand rises and inventory remains low . Strong household balance sheets amongst homeow ners has kept fundamentals strong as w ell. How ever, many of these bonds are now call-constrained. ■ CMBS: the vaccine new s was a wake-up call to an asset class that continued to underperform on w orries about the future of the office and travel. The stories across subsectors vary widely, how ever.	■ 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 draw n dow n and mortgage forbearance increases.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	■ o/w Copper vs Aluminium ■ o/w Lead vs Zinc ■ o/w Soybeans vs Corn and Wheat ■ o/w refining margins (o/w products, u/w Brent)	■ Oil production disruption

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