COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

In Credit

7 DECEMBER 2020

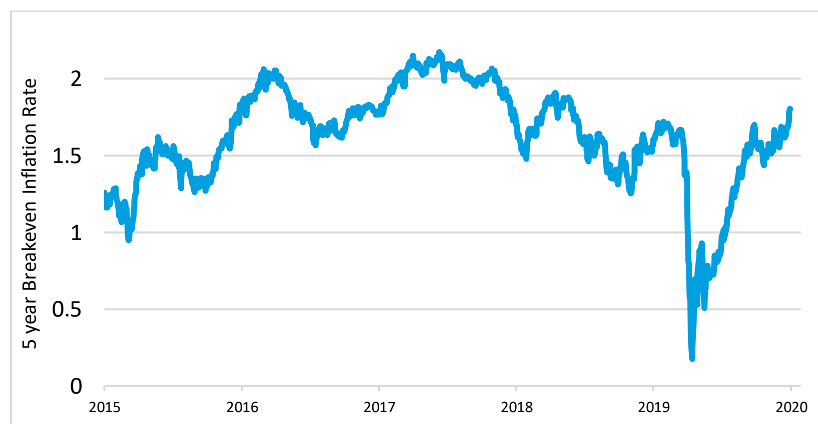
'It's inflation Jim - but not as we know it'.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.94%	11 bps	-0.9%	7.6%
German Bund 10 year	-0.58%	1 bps	-0.3%	2.7%
UK Gilt 10 year	0.30%	2 bps	-0.7%	6.2%
Japan 10 year	0.02%	-1 bps	0.0%	-0.8%
Global Investment Grade	105 bps	-6 bps	-0.3%	6.9%
Euro Investment Grade	92 bps	-2 bps	0.0%	2.5%
US Investment Grade	107 bps	-6 bps	-0.5%	8.8%
UK Investment Grade	100 bps	-3 bps	-0.1%	6.3%
Asia Investment Grade	237 bps	-2 bps	-0.1%	5.8%
Euro High Yield	362 bps	-20 bps	0.6%	2.7%
US High Yield	403 bps	-32 bps	0.8%	5.0%
Asia High Yield	623 bps	-26 bps	0.6%	5.2%
EM Sovereign	331 bps	-18 bps	0.6%	4.6%
EM Local	4.3%	-1 bps	1.8%	1.1%
EM Corporate	336 bps	-18 bps	0.3%	6.0%
Bloomberg Barclays US Munis	1.2%	-1 bps	0.1%	4.6%
Taxable Munis	2.3%	5 bps	-0.7%	9.8%
Bloomberg Barclays US MBS	45 bps	-5 bps	-0.1%	3.5%
Bloomberg Commodity Index	156.61	-0.7%	-0.1%	-7.8%
EUR	1.2114	1.3%	1.6%	8.1%
JPY	104.17	-0.1%	0.1%	4.3%
GBP	1.3288	1.0%	0.9%	1.4%

Source: Bloomberg, Merrill Lynch, as at 4 December 2020.

Chart of the week: Rising US inflation expectations (2015-20)



Source: Bloomberg and Columbia Threadneedle Investments, as at 4 December 2020.

David Oliphant
Executive Director,
Fixed Income

Contributors

David Oliphant
Macro / Government bonds, Investment Grade Credit

Angelina Chueh
Euro High Yield Credit, Emerging Markets

Chris Jorel
US High Yield Credit, US Leveraged Loans

Katherine Nuss
US Investment Grade Credit

Kris Moreton
Structured Credit

Justin Ong
Asian Fixed Income

Doug Rangel
Municipals

Charlotte Edwards
Responsible Investments

Jake Lunness
Commodities

Macro / government bonds

There were two clear themes unfolding in macro markets in the last week. The first is rising inflation expectations and the second is a lower US dollar.

In a period when the quantity of money (money supply) has ballooned so breakeven levels have risen. 5-year US inflation expectations approached nearly 1.8% at one point last week, which is the highest level in around 18 months and a huge rise from the 0.2% level seen at the height of the crisis in March of this year (**see chart of the week**). Should inflation be about to rise the present level of interest rates and (of course) bond yields is at risk.

However, before we get too alarmed there are a number of mitigating factors to entertain. Firstly the velocity of money has collapsed. Secondly as one of my colleagues puts it – 'If the pandemic has speeded up previous secular trends does it not also speed up the ongoing switch to online retail / price comparison transparency and the deflationary impact of technology (including 'Amazonification' and work from home) as well?'. This adds to the embedded effects of an ageing population (with a higher propensity to save than spend); deunionisation (and the end of effective collective bargaining); the burden of high levels of soveriegn and corporate debt on economies; and of course weak GDP growth in most regions. As we end the year inflation concerns have risen but real yields are as low as they ever have been. Indeed the difference between the two is in the 95th percentile of observations seen in nearly 20 years. We remain in the disinflation camp.

The second feature is that of the falling US dollar and its recent breakthrough of the psychologically important 1.2 level versus the euro **(see second chart of the week)**. As our Macro team points out the long-term path of the dollar continues to point lower, given twin deficits and expensive valuations. In its view, higher risk markets (equities and credit) along with better global growth tend be good explanatory variables for the US currency. To the extent that Covid vaccine optimism feeds into higher growth/risk, we should expect a weaker dollar but we note that weakness appears to have gotten a little ahead of itself – in the near term. There's also the US election, the strong US dollar of 2018/19 was a function of 'America First' /tariffs/fiscal expansion leading to US growth outperformance. Now we seem to have fiscal gridlock without a 'blue sweep' so the US is less likely to outperform on a growth basis and President-elect Biden will probably take a less hardline approach to China tariffs, which supports a stronger RMB. A stronger RMB is good for other Asian FX and results in central bank intervention, which means US dollar accumulation that then gets recycled into euros to rebalance reserves.

Second chart of the week: The falling US dollar in 2020

Source: Bloomberg and Columbia Threadneedle Investments, as at 4 December 2020.

Investment grade credit

Investment grade markets like other 'risk assets' are enjoying a 'purple patch' as we head into year end.

Credit spreads were marginally tighter across the board last week as it followed muted primary issuance due to the Thanksgiving holidays. New issues have started to trickle through, but this is expected to stay low as we enter the Christmas seasonal lull.

High yield credit

US high yield bond prices continued their rise over the past week amid optimism surrounding a vaccine and fiscal stimulus package. The ICE BofA US HY CP Constrained index returned 0.83% and spreads were 30bps tighter over the week. With the strong risk-on- tone across markets, CCCs continued to outperform, returning 1.71% over the week vs. 0.63% and 0.81% returns for BB and B-rated issuers, respectively. New issuance has begun its seasonal decline into year-end with approximately $4.5 billion issued over the week. According to Lipper, the asset class saw a $1.4 billion outflow for the week, snapping a 3-week inflow streak.

It was also another strong week for European High Yield (EHY) as the market goes into the last month of 2020. Spreads tightened in another 20bps, to 362bps as the market rallied on the positive vaccine news. CCC outperformed both BB and B, again, by almost 3x over the week. Inflows slowed down to €148 million, mainly into ETFs. With 2020 coming to an end and looking ahead to 2021, given the expectation of continued central bank asset buying, further compression is supported.
Primary market picked up over the week with €3.2 billion new issuance, including Autostrade (€1.8 billion), one of this year's Fallen Angels. Other names included Webuild (€550 million) and €500 million convertibles by Accor. This brings year-to-date issuance to almost €98 billion, not far from the all time high seen in 2017 of €101 billion.
In sector news, French car sales were down 27% for November to 126k, a huge improvement to the -89% seen in April. Interestingly, electric vehicle sales were 6.2% vs 1.9% of total monthly sales seen 12 months ago.
In stock specific news, Europcar is looking to enter Sauvegarde and Chapter 15, without triggering a default on its bonds. As the firm has already missed paying the recent coupons, this feels like a necessary step to completing restructuring.
The default picture for EHY continues to look relatively subdued with JPMorgan lowering its default outlook to 2%, saying that the nature of the default cycle currently means that the compensation required for default is lower than before.

US leveraged loans

Leveraged loan prices also continued to climb over the past week as broader markets are responding favourably to progress on vaccines and renewed optimism over stimulus talks. The average price of the J.P. Leveraged loan index increased +$0.39 to $96.47 over the past week with the average price for BB loans increasing $0.29 to $98.31, Single B loans increasing $0.38 to $97.92, and Split B/CCC increasing $0.64 to $85.35. Yields and spreads (3-year) decreased 15bps and 14bps over the past week to 5.33% and 506bps. This is the lowest yield for the Loan index since April 2015, although spreads of 506bps compare to as low as 441bps in January 2020. The asset class experienced another modest outflow of $9 million.

Structured credit

The Agency MBS market posted a negative return of 11bps, which outperformed its high-quality peers, such as treasuries and corporate bonds, as the market bear steepened. Bonds directly in the path of the US Fed (ie, lower coupons) materially tightened while higher coupons widened. CMBS spreads rallied across the stack. AAA spreads have come full-circle and are now trading at year-to-date tights. Lower in the stack, spreads were tighter on improved appetite from both money managers and hedge funds who appear to be looking beyond a second Covid wave and towards an improved 2021.

Emerging markets

EMD also saw another strong week as hard currency and corporate spreads tightened in 9bps and 12bps, respectively. Local EM also had good week, returning 1.6%, largely due to FX moves as US dollar weakness continued. Inflows moderated but were still strong at $2.7 billion, in both hard and local currencies, with local EM again being the larger recipient this week.

On the rating front, Fitch lowered Malaysia's rating from A- to BBB+ while S&P and Fitch took Guatemala off credit watch negative, re-affirming the rating of BB-. Offsetting this was Moody's decision to change Colombia's outlook from stable to negative. This comes even as central bank co-director Maiguashca said that monetary stimulus will remain for a long time. The move may give Colombia the extra push to make quick work of the tax reform it plans to propose in Q1, 2021. On a country basis, in Brazil, President Bolsonaro announced that Covid cash handouts will not be extended past the end of 2020. Brazil's Q3 growth showed a rebound of 7.7% q/q (-3.9% y/y) supported by investments (+11% q/q) and consumption (+7.6% q/q). In Chile, Congress approved the second round of pension withdrawals. In Russia, it was announced that Covid-19 vaccinations will start shortly.

Asian fixed income

The US Department of Defense has added four more Chinese companies to its list of Communist Chinese military companies – these are SMIC, China National Offshore Corp, China International Engineering Consulting Corp and China Construction Technology. In total, 35 companies have been designated as Communist Chinese military companies.

Moody's downgraded the corporate family rating of Vedanta Resources Limited (VRL) from B1 to B2 and the senior unsecured ratings from B3 to Caa1. The ratings remain under review for further downgrade. The negative rating action was driven by the weak liquidity of high refinancing needs of VRL. VRL has also announced a tender offer for its $670 million of bonds maturing in June 2021, which will be funded by a proposed issuance of 3-year bond.

For Geo Energy, the independent JORC consultant (SMG Consultants) stated that the coal reserves of SDJ and TBR have a combined coal resource of 110.6 million tonnes and combined coal reserves (proved and probable) of 86.4 million tonnes (as at 31 October). Accordingly, the minimum qualified coal reserve requirements of the GERLSP '22s notes have been meet and the mandatory offer to purchase covenant will fall away. This is a positive for Geo Energy because it is no longer compelled to purchase the GERLSP '22s notes in April 2021, ahead of the bond maturity in October 2022.

Commodities

The commodity index was down by 0.7% last week. Crude rallied 2.5%; OPEC+ agreed to raise production by 0.5 million barrels per day from January, then hiking production by a maximum of 0.5 million bpd in each following month. Heating oil rallied by 0.7%; however, natural gas was down 10% due to the warm weather on the American East Coast.

Industrial metals rallied 1.4%, led by copper and aluminium climbing 4.8% and 3.3% respectively. Aluminium prices have been supported by the pick-up in global manufacturing activity and speculative positions from traders. Iron ore rallied 9.4% as China's imports exceeded 1 billion tons year-to-date, exceeding the overall 2019 volume. Brazilian mining company Vale SA also lowered its production targets for this year. In precious metals, gold rose 2.7% with silver rallying 7.2%.

Grains were down last week due to both China staying away from the market and weather conditions in Argentina and Brazil.

Responsible investments

Coca Cola Europe is to spend €250 million over the next three years to help in its fight to be net zero by 2040. Its carbon output has already fallen 31% since 2010 but the firm still produces an almighty 3.7 million tonnes each year. Roughly the same amount of output as the annual emissions of Iceland (according to Bloomberg).

In Germany, Deutsche Bank has said that starting next year its top executives' pay will be linked to the sustainability goals of the bank and be affected by how those goals have been met. It will include both how the bank is rated on sustainability by agencies, as well as the amount of sustainable financing and investment that meets environmental, social and governance standards.

In issuance news, green bonds in November alone raised $37 billion, a huge $30 billion increase from the previous month. This now takes the total issuance year-to-date to a $291.9 billion, a y/y increase of 12%. As impressive as this is, the total of social bond issuance currently stands at $143.3 billion, a whopping 715% increase y/y, after November issues added $33.6 billion. Pandemic bond issuance (proceeds of which are used to support healthcare, businesses and job losses) now totals $128.6 billion.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

4th 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 (■ at +1)	■ 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 worries a potential vaccine would underwhelm.	■ The 'bridge' of policy support ends before getting to the other side of the fundamental economic slowdown. ■ The virus outbreak becomes completely untenable to maintain commerce functioning. ■ Hiring grinds back to a halt while unemployment remains elevated ■ Vaccine development slows.
Duration (10-year) ('P' = Periphery)	Short -2 -1 0 +1 +2 Long (¥ at 0; P, $, £, € at +1)	■ Renewed virus concerns and economic disruption to keep nominal growth subdued ■ Reflation credibility still low, despite Fed framework review ■ Fed QE and high personal savings underpin demand for treasuries ■ ECB readying new stimulus effort, while supply declines ■ Duration remains best hedge for further risk asset correction	■ Vaccine development pace exceeds expectations, permitting rapid normalisation ■ Permanent fiscal policy shift rebuilds reflationary credibility ■ Fiscal largesse steepens curves on issuance expectations ■ Risk hedge properties deteriorate
Currency ('E' = European Economic Area)	Short -2 -1 0 +1 +2 Long (E at -1; ¥, EM, A$, $ at 0; £ at +1)	■ A Biden presidency should see a weaker dollar through the reduction of trade war risk premium. ■ Longer term, expensive valuations and twin deficits presage a weaker Dollar	■ Fiscal gridlock continues in the US, which undermines growth and risk sentiment ■ Extension of Covid restrictions in Europe and accommodative ECB policy
Emerging Markets Local (rates (R) and currency (C))	Under-weight -2 -1 0 +1 +2 Over-weight (R and C at +1)	■ 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 (■ at +1)	■ Tail risks that would acutely affect EM have passed. Exposure to goods/commodities production and China have been positives as well. ■ 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 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 (■ at 0)	■ IG companies continue to adapt well 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 (■ at 0)	■ 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 weaker balance sheets and the exposure to COVID-hit sectors, the positive vaccine news is an appreciated support for fundamentals	■ Prolonged COVID-19 related slump in activity would 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 well-inside averages
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight (■ at 0)	■ The Fed's QE including Agency MBS has been a significant tailwind for a sector with 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 overwhelming the market.	■ 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 (■ at +1)	■ RMBS: Housing has been a major outperformer in this recovery, as demand rises and inventory remains low. Strong household balance sheets amongst homeowners has kept fundamentals strong as well. However, many of these bonds are now call-constrained. ■ CMBS: the vaccine news was a wake-up call to an asset class that continued to underperform on worries about the future of the office and travel. The stories across subsectors vary widely, however.	■ 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 (■ at +1)	■ o/w Copper vs Aluminium ■ o/w Lead vs Zinc ■ o/w Soybeans vs Corn ■ o/w refining margins (o/w products, u/w Brent)	■ Oil production disruption

Important information: For use by Professional and/or Qualified Investors only (not to be used with or passed on to retail clients). Source for all data and information is Bloomberg as at 07.12.2020, unless otherwise stated.

The material in this publication is for information only and does not constitute an offer or solicitation of an order to buy or sell any securities or other financial instruments to anyone in any jurisdiction in which such offer is not authorised, or to provide investment advice or services. Offerings may be made only on the basis of the information disclosed in the relevant offering documents and the terms and conditions under the relevant application forms. Investment involves risk. You are advised to exercise caution in relation to this material. Please refer to the relevant offering documents for details and the risk factors. Past performance is not a guide to future performance. This is an advertising document. The value of investments and any income is not guaranteed and can go down as well as up and may be affected by exchange rate fluctuations. Your capital is at risk. This means that an investor may not get back the amount invested. The analysis included in this publication have been produced by Columbia Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice and should not be seen as investment advice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed. The mention of any specific shares or bonds should not be taken as a recommendation to deal. This document includes forward looking statements, including projections of future economic and financial conditions. None of Columbia Threadneedle Investments, its directors, officers or employees make any representation, warranty, guarantee, or other assurance that any of these forward looking statements will prove to be accurate. This document may not be reproduced in any form or passed on to any third party in whole or in parts without the express written permission of Columbia Threadneedle Investments. This document is not investment, legal, tax, or accounting advice. Investors should consult with their own professional advisors for advice on any investment, legal, tax, or accounting issues relating an investment with Columbia Threadneedle Investments. This document and its contents have not been reviewed by any regulatory authority.

Issued by Threadneedle Investments Singapore (Pte.) Limited ["TIS"], ARBN 600 027 414. TIS is exempt from the requirement to hold an Australian financial services licence under the Corporations Act and relies on Class Order 03/1102 in marketing and providing financial services to Australian wholesale clients as defined in Section 761G of the Corporations Act 2001. TIS is regulated in Singapore (Registration number: 201101559W) by the Monetary Authority of Singapore under the Securities and Futures Act (Chapter 289), which differ from Australian laws.
Issued by Threadneedle Investments Singapore (Pte.) Limited, 3 Killiney Road, #07-07, Winsland House 1, Singapore 239519, which is regulated in Singapore by the Monetary Authority of Singapore under the Securities and Futures Act (Chapter 289). Registration number: 201101559W. This advertisement has not been reviewed by the Monetary Authority of Singapore. Issued by Threadneedle Portfolio Services Hong Kong Limited 天利投資管理香港有限公司. Unit 3004, Two Exchange Square, 8 Connaught Place, Hong Kong, which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 regulated activities (CE:AQA779). Registered in Hong Kong under the Companies Ordinance (Chapter 622), No. 1173058.
Issued by Threadneedle Asset Management Limited (TAML). Registered in England and Wales, Registered No. 573204, Cannon Place, 78 Cannon Street, London EC4N 6AG, United Kingdom. Authorised and regulated in the UK by the Financial Conduct Authority.
This document is distributed by Columbia Threadneedle Investments (ME) Limited, which is regulated by the Dubai Financial Services Authority (DFSA). For Distributors: This document is intended to provide distributors with information about Group products and services and is not for further distribution. For Institutional Clients: The information in this document is not intended as financial advice and is only intended for persons with appropriate investment knowledge and who meet the regulatory criteria to be classified as a Professional Client or Marketing Counterparties and no other Person should act upon it.

Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies. columbiathreadneedle.com