INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

8 FEBRUARY 2021

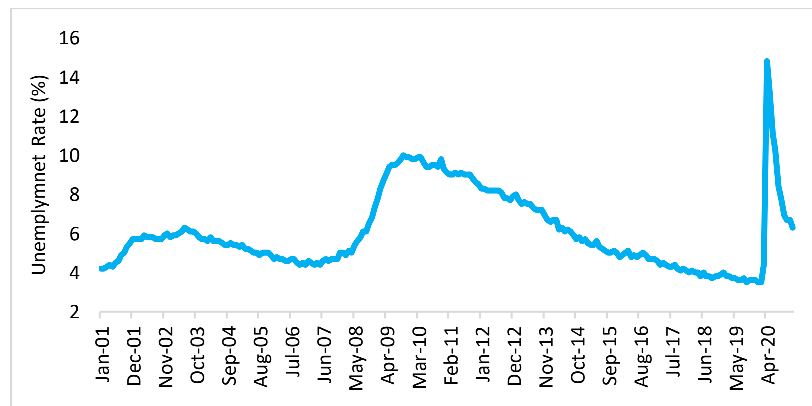
Less interest, in negative interest rates.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.16%	10 bps	-0.6%	-1.7%
German Bund 10 year	-0.44%	8 bps	-0.7%	-1.1%
UK Gilt 10 year	0.49%	17 bps	-2.3%	-4.0%
Japan 10 year	0.07%	2 bps	0.0%	-0.3%
Global Investment Grade	98 bps	-4 bps	-0.3%	-1.1%
Euro Investment Grade	88 bps	-5 bps	0.0%	-0.1%
US Investment Grade	99 bps	-3 bps	-0.3%	-1.5%
UK Investment Grade	95 bps	-4 bps	-1.0%	-1.9%
Asia Investment Grade	224 bps	-4 bps	0.1%	0.2%
Euro High Yield	335 bps	-19 bps	0.7%	1.2%
US High Yield	358 bps	-21 bps	0.7%	1.1%
Asia High Yield	588 bps	7 bps	0.1%	0.0%
EM Sovereign	311 bps	-13 bps	0.5%	-0.7%
EM Local	4.3%	0 bps	0.3%	-0.8%
EM Corporate	316 bps	-7 bps	0.3%	0.3%
Bloomberg Barclays US Munis	0.9%	-1 bps	0.1%	0.7%
Taxable Munis	2.2%	5 bps	-0.7%	-0.8%
Bloomberg Barclays US MBS	12 bps	-6 bps	0.0%	0.1%
Bloomberg Commodity Index	178.10	3.0%	3.0%	5.7%
EUR	1.2049	-0.7%	-0.7%	-1.4%
JPY	105.20	-0.6%	-0.6%	-2.0%
GBP	1.3741	0.2%	0.2%	0.5%

Source: Bloomberg, Merrill Lynch, as at 5 February 2021.

Chart of the week: US unemployment rate (2001-2021)



Source: Bloomberg, Columbia Threadneedle Investments, as at 5 February 2021.

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Macro / government bonds

It was a game of two halves for macro markets last week. Italy won in the end, with the UK coming last. For Italian bonds, spreads are now some 10% tighter so far this year while UK gilts are underperforming with yields now around 30bps higher over the same period. Why so? The markets were relieved and supportive of Mario Draghi's likely formation of a new technocrat government in Italy. In the UK, however, the Bank of England noted current economic weakness but suggested (in the wake of a very successful vaccination programme) that the economy will rebound. It has also dampened expectations of imminent negative interest rates. This more hawkish tone helped sterling to rally and gilts to fall in price.

Elsewhere, the reflation theme continues to undermine confidence in rates' markets with US expectations back to recent highs (around 2.2%). At the end of the week, the employment report showed a surprisingly low amount of jobs created (49k versus expectations of 105k). In better news the rate of unemployment fell again to 6.3% from 6.7% (remember this rate was as high as 14.8% in April of last year see **chart of the week**). Wages grew by two tenths to 5.4% y/y.

Investment grade credit

Corporate bond spreads continued to tighten with the Global Index ending the week at 98bps over government bonds. These spreads are now some 5% tighter year-to-date with euro-denominated debt marginally outperforming. Investment grade has not managed to keep pace with high yield markets, however, which are 7-9% tighter in 2021.

Better news on the vaccine roll-out in the US and UK supports sentiment. Markets remain supported by hopes of a US fiscal package and the expectations of a relatively light calendar of new issuance this year. Corporate earnings have in general been supportive, as well with around two thirds of companies beating expectations in Europe, as an example. The news that Mario Draghi is likely to form a government in Italy benefitted the spreads of Italian issuers.

The rise in government bond yields described above has been more of an effect on investment grade credit given the increase in duration of the market in recent years. Notably the Global index, which presently has an effective duration of around 7.3 years, has increased by over a year in the last five years. The increase in interest rate risk has been most pronounced in the US dollar market.

High yield credit

US high yield bond yields returned to a record low over the past week alongside a 4.75% gain for the S&P 500 amid inflows, better than expected earnings and optimism surrounding negotiations on a fiscal package and the vaccine rollout. The ICE BofA US HY CP Constrained index returned 0.72% and spreads were 22bps tighter. Meanwhile, the yield-to-worst on the same index declined to 3.99%, an all-time low. New issuance moderated somewhat from January's record seasonally-adjusted pace with $7.1bn issued over the week. The asset class reported a $1.3bn inflow following outflows over six of the previous seven weeks.

European high yield spreads tightened back in (-19bps) last week, with higher coupons bonds especially in demand, even as outflows picked up with €407m, largely out of managed accounts. The market was well balanced with good price action, both ways. The primary market started February with a strong start as €3.7bn was added to the universe, with new issues well over subscribed. Issuers included Telefonica (€1bn), Lufthansa (€1.6bn with part of the proceeds

being used to pay back some of the state aid support), Kloeckner Pentaplast (recycling) and Forno D Asolo (€350m). This brings high yield corporate issuance to €19.2bn year-to-date, just ahead of last year's figure for the same period.

In issuer specific news, Vallourec (French metals and mining) has reached an agreement in principle with its main creditors while it restructures its debt. With the bonds now pricing in the mid-high 80's, it appears that despite defaulting / restructuring, bondholders don't appear to be any worse off.

In M&A news, Cellnex is buying Towers from SFR. EG Group announced plans to buy ASDA for £750m. Enquest announced an acquisition as well as an in-line trading update. The main positive is that financing will include a new secured credit facility, which will also refinance the existing facility. The trading update looks in line with a slight outperformance on debt reductions. Finally, the UK debt collector Arrow Global Finance announced a takeover bid from TDR Capital. Apparently, there had been three previous offers, all of which were rejected by the board. The latest offer now has the backing of the CIO and founder. As the Arrow bonds are already pricing above par, there was limited price action.

Leveraged loans

Leveraged loan prices recovered modestly alongside broader market strength as investors absorbed better than expected earnings and a steeper yield curve in response to stimulus prospects and the vaccine rollout. The asset class reported a fourth consecutive sizable inflow totalling $834m with the latest stretch of inflows the most pronounced since January 2017. That said, despite recovering $0.10 over the past three sessions, leveraged loan prices of $98.09 are still $0.19 below January's high. Meanwhile, loan yields and spreads (3-year) were unchanged and decreased 2bps over the past week to 4.77% and 449bps, respectively.

Structured credit

Returns in the US Agency MBS market were flat last week. Rates continued to bear steepen on expectations of more fiscal stimulus pushing breakeven inflation rates to levels not seen since 2014. Higher coupon mortgages outperformed against this backdrop. Prepays have started to slow; 30-year conventional speeds came in 5% slower. Agency gross issuance remained elevated at $335bn. In Non-Qualified RMBS, premiums hit new highs of all-time tight bond spreads. Reperforming loans are also grinding tighter. Non-QM loan originations remain light on originators focus on capacity in an environment of historically high refi eligibility rates. CMBS spreads steepened on excess supply. Dealers net sold $220m this past week, after adding a sizeable $550m the previous week.

Emerging markets

Emerging markets echoed the global strength theme last week as spreads tightened in for both hard currency sovereign and corporate debt. Strong flows into the asset class continued for another week with an additional $4bn, mostly into hard currency funds ($3bn) with the majority into managed funds.

In central bank news, India's RBI left its policy rate unchanged at 4% as expected and reiterated its pledge to ensure ample liquidity, reassuring the market that it will see the government

complete its borrowing plan in a 'non-disruptive manner.' Thailand also kept rates at 0.50% but made clear that the option remains for further easing if necessary. For now, the country is looking to use more fiscal measures.

In credit rating news, Panama was downgraded to BBB- by Fitch. The rating agency cited concern over weakening public finances. However, given the new government's more reform minded stance, there isn't an expectation that the country will fall to high yield status.

The primary market was strong with issuers like Alibaba, Pertamina, Continuum Energy (green bond in the India renewable sector), Volcan (Peru mining), and CFELEC (government-owned Mexican utility).

In country specific news, Ecuador announced a delay in the reform bill until after the upcoming presidential elections. Passage of the bill is critical for approval of the $400m IMF package. Surprisingly Ecuador bonds did not react to the announcement. There was some good news for South Africa as Ford, the auto manufacturer, announced it would spend $1bn in South Africa investment (this comes as they close their two plants in Brazil.)

Asian fixed income

Several Asian companies continue to come under liquidity pressure and downside ratings risk. Moody's downgraded GCL New Energy to Caa3 with an outlook negative to reflect the default on the $500m note. Moody's also downgraded China Fortune Land to Caa1 from B2 and changed the outlook to 'ratings under review' (previous: outlook negative) due to the missed principal and interest payment. In Indonesia, Pan Brothers obtained the approval to extend the maturity date of its syndicated loan to 12 February while negotiations continue for a longer extension of the loan.

In Thailand, Moody's affirmed PTTEP's Baa1 ratings following the latter's purchase of a 20% stake in the Block 61, which is a producing onshore gas block in Oman. While the acquisition will lower PTTEP's cash reserves, PTTEP will improve its scale of productions and reserves.

Commodities

The commodity index rallied 3.0% last week taking year-to-date returns to 5.7%. Energy had a stellar week, with WTI and Brent rallying 8.9% and 7.8% respectively. Brent finished the week just shy of $60 barrel. Aside from demand recovery crude has been buoyed by onshore tanks and floating storage supply volume shrinking by around 300 million barrels since OPEC's deep cuts in May 2020. The crude curve is currently in backwardation, which is drawing in investment from macro funds. Despite the rally, the US rig count was only 392 last week, compared to over 700 in March 2020. Natural gas prices rose by 11.6%, driven by colder weather on the US east coast.

Base metals rallied 2.2% last week despite the anticipated slowdown for the upcoming Chinese New Year celebrations. Notable outperformers were zinc (+3.3%) and tin (+2.7%).

Agricultural commodities were up marginally (+0.2%) last week following the strong performance over the recent weeks. Investors are poised for the latest US Department of Agriculture WADSE report coming on Tuesday, markets expectations are that the US will cut its stockpiles outlook. Meanwhile, Argentina's president threatened taxes/quotas on food exports as the country grapples

with inflation. This comes following criticism that farmers sell food at home for the same prices they export; Argentina is South America's largest wheat and corn producer.

In precious metals, gold declined by 2.0% and silver rallied by 0.4%. Gold rallied on the morning of Monday 8 February as investors sought protection from higher inflation expectations. In silver, volatility eased as the iShares silver ETF fell from record levels as the Reddit-induced rally ended.

Responsible investments

Bank of America has announced it will be pledging $10bn to support those struggling to secure their own home. Those in low- and moderate-income communities could be entitled to a $10,000 down payment assistance, as well as money to cover legal fees.

According to Carbon Monitor (national database that tracks daily carbon dioxide emissions), China was the only major economy to increase its carbon emissions over 2020. Globally it was reduced by 4.4% with Spain and the US topping the table with the highest reductions (-13.1% and -12.5% respectively).

In the UK, Government permission to construct a new coal mine could hinder the current efforts being made to hit the climate target for 2030. The West Cumbrian mine has received permission to keep mining right up until just one year before the country has set to be net-zero emissions in 2050. The local council defended its approval by saying it would create 500 jobs as well as avoid another country having to open a mine to meet the demand for fossil fuels. It's seen by some as a controversial move by the UK government who have set to phase out coal in electricity generation by 2025 but haven't set a hard deadline to stop the mining of coal.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

8th February 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	■ 2021 has started with continued positive credit performance – and not for nothing: fundamentals in 2021 should continue to improve as economic activity normalizes amid more widespread vaccination. ■ Despite this outlook, valuations matter. Most spread sectors are well inside long-term averages. ■ We have likely already seen peak liquidity in financial markets. We do not expect material tightening in financial conditions next year, but spreads at these levels no longer offer cushion for unforeseen hiccups. ■ We have a modestly positive outlook but realistic returns are lower than in 2020.	■ Moving to neutral, risks are two-sided. ■ A recovering economy propels spreads to all-time tights. ■ The recovery gets bungled by vaccine delays, geopolitical interruptions, or a limping back to normality in the services sector
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long £ €	■ Renewed virus concerns and economic disruption to keep nominal growth subdued ■ Reflation credibility still low, although risks from fiscal policy ■ Fed QE and high personal savings underpin demand for treasuries ■ ECB bond buying scheme supports Eurozone market ■ Duration remains best hedge for further risk asset correction	■ Very aggressive re-normalisation of consumption ■ Permanent fiscal policy shift rebuilds reflationary credibility and raises r* ■ Fiscal largesse steepens curves on issuance expectations ■ Risk hedge properties deteriorate
Currency ('E' = European Economic Area)	¥£ EM Short -2 -1 0 +1 +2 Long A$ E $	■ 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 ■ Failure to pass substantial fiscal package in US
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ Favourable advanced economy policy settings support EM assets in 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	■ EM economies have been given very long leashes to respond to COVID: deficits and debt have skyrocketed with no plans for reigning them in. Any slowdown will likely exacerbate these 'back burner' issues. ■ Valuations are still a slight benefit to EM, particularly EM HY credits. ■ Low yields, lots of liquidity, and global recovery still could provide tailwinds for EM in 2021.	■ 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. ■ Governments show little willingness to address deficits post-COVID.
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	■ IG companies continue to adapt well to the economic environment, given that they are the best-in-class operators in their industries. ■ Valuations are the biggest drawback: with spreads this tight, widening could very quickly more than offset carry. ■ Technicals remain strong, especially as global investors survey the universe of high-quality assets and see extremely low government bond yields.	■ IG bonds further cement their place in global investors' portfolios as safe assets, replacing government bonds. ■ Management teams eschew M&A and shareholder return in order to continue to pay down debt during the recovery.
High Yield Credit	Under-weight -2 -1 0 +1 +2 Over-weight	■ Spreads are inside LT averages, even adjusting for the better quality of today's index. But higher yields give more cushion than slightly higher quality bonds. ■ The ability to access financing has dramatically improved the prospects for many companies, especially for COVID-affected industries. ■ The positive effects of easy financial conditions hit HY later than higher quality sectors, and tighter conditions will hit HY first.	■ Upside risks include: intensified reach for yield keeps drawing new investors, M&A lifts HY companies into larger IG conglomerates. ■ Downside risks include:travel & leisure habits slowly revert to pre-COVID, commodity sell-offs, or financial conditions suddenly tightening.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ Fed buying has overwhelmed highly negative fundamentals, as seen by the near-zero spreads in bonds the Fed buys and poor performance elsewhere. ■ Fed buying cannot be expected to increase in 2021, exposing negative fundamentals and valuations ■ Prepays remain and will remain high, with >70% of mortgages having incentive to refinance.	■ 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	■ 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: vaccine news reminded investors that a post-COVID world will exist, and CMBS short covering has been fast & furious.	■ 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 ■ o/w Lead vs Zinc ■ o/w Soybeans vs Corn ■ u/w Sugar ■ u/w WTI	■ Oil production disruption

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