COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

15 MARCH 2021

Inflated inflation fears.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.62%	5 bps	-1.0%	-4.4%
German Bund 10 year	-0.31%	0 bps	0.0%	-2.4%
UK Gilt 10 year	0.84%	9 bps	0.2%	-7.3%
Japan 10 year	0.11%	2 bps	0.6%	-0.6%
Global Investment Grade	100 bps	2 bps	-0.5%	-3.4%
Euro Investment Grade	89 bps	0 bps	0.2%	-0.7%
US Investment Grade	102 bps	2 bps	-1.7%	-4.8%
UK Investment Grade	94 bps	2 bps	-0.1%	-4.0%
Asia Investment Grade	208 bps	2 bps	-0.4%	-0.9%
Euro High Yield	323 bps	-12 bps	0.3%	1.4%
US High Yield	355 bps	-5 bps	-0.2%	0.5%
Asia High Yield	560 bps	1 bps	-0.4%	0.1%
EM Sovereign	326 bps	-6 bps	-0.9%	-4.6%
EM Local	4.9%	6 bps	-1.3%	-5.0%
EM Corporate	303 bps	2 bps	-0.6%	-0.8%
Bloomberg Barclays US Munis	1.1%	-7 bps	0.7%	-0.2%
Taxable Munis	2.5%	6 bps	-2.0%	-4.5%
Bloomberg Barclays US MBS	11 bps	-1 bps	-0.3%	-0.9%
Bloomberg Commodity Index	183.38	0.1%	0.8%	10.1%
EUR	1.1922	0.3%	-1.0%	-2.2%
JPY	109.19	-0.6%	-2.3%	-5.2%
GBP	1.3919	0.6%	-0.1%	1.9%

Source: Bloomberg, Merrill Lynch, as at 12 March 2021.

Chart of the week: Inflation expectations vs Core CPI.

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

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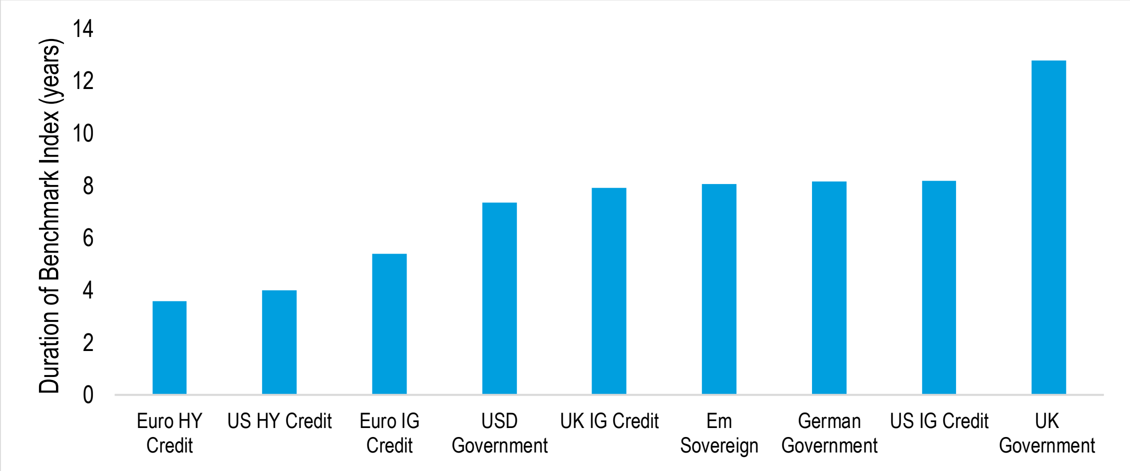
Macro / government bonds

For bond markets, this year has been all about rising inflation expectations and more recently real yields.

This has pushed yields higher and dented total returns for areas of fixed income with higher levels of interest rate risk. The effect such moves have depends on the interest rate sensitivity (duration) of the market index. **The second chart of the week** ranks a few key markets by their duration and shows, for example, that UK gilts stand out as the most sensitive market. Meanwhile, high yield markets offer a more dampened relationship to changing government bond yields.

Second chart of the week: Duration of key fixed income markets



Source: Bloomberg, ICE BoML, JP Morgan, Columbia Threadneedle Investments, as at 11 March 2021.

In the US inflation has averaged 2% over the last 20 years. As mentioned, the present expectation for inflation in the coming 10 years has risen and is now above this rate (around 2.3%), having been around a quarter of this during the 'eye' of last year's Covid-19 storm. Against that backdrop, the key US consumer price inflation report was released last week. At a headline level, it rose strongly, albeit no more strongly than expected (the rise in energy prices was to blame). Most importantly, at a core level (excludes the often-volatile shifts in food and energy prices) the move higher was modest and only 0.1% over the month. This was less than expected (for the third consecutive month) and takes the core rate lower to 1.3% y/y. **The chart of the week** shows the difference between inflation expectations and historic / present core inflation. It shows that we are in the 93rd percentile of observations over the last 20 years.

We already know that the next few months data will be skewed by base effects, from the various programmes that were brought to bear last year, but the balance in the inflation/disinflation debate may have taken a step back towards the disinflationist camp. Nonetheless, yields headed to new highs.

Last week in Europe, the ECB as expected left interest rates unchanged. The central bank does expect to increase the pace of bond purchases in the face of recent rising yields, and the unwanted tightening in financial conditions that this brings. This more dovish stance was not rewarded with relatively (to the US and UK) lower yields.

Investment grade credit

Credit spreads have 'sneaked' wider in the last couple of weeks led from the US dollar market. Investment grade markets are still a little tighter in spread than at the start of the year.

In the US, higher yields (borrowing costs) have 'scared' issuers into frontloading new issuance, which has caused a degree of indigestion. Notable issuers include Verizon ($25bn) with its 'C Spectrum' funding programme last week.

In Europe, earnings season has been encouraging with a general commitment to balance sheet conservatism. By the end of this year, credit quality is expected return to be in a similar state to the conditions that prevailed at the end of 2019. Technicals are more supportive with lower primary market activity and, of course, the support from buying by the ECB.

When we compare valuations between the two markets, valuations are similar with the US around 0.7 standard deviations (SD) rich to the long term (20-year) average. The equivalent metric in Europe is similar at around -0.5 SD rich.

High yield credit

US high yield bond prices fell modestly over the past week amidst heightened flow and rate volatility. The ICE BofA US HY CP Constrained Index returned -0.04% for the week with spreads 4bps tighter and yields slightly higher at 4.35%. New issue activity remains elevated with more than $18bn pricing during the week. Use of proceeds remains heavily tilted towards refinancing. According to Lipper, the asset class reported a $5.3bn outflow for the week, $3.9bn of which was ETF driven. This represents the largest outflow since July.

European high yield had a reasonably strong performance, helped by the ECB's modest easing action last week. Spreads tightened in 12bps, returning to 323bps (1bps shy of the year-to-date lows) with higher beta credits outperforming, again. Hybrids also snapped back with the market covering shorts on the back of the strong equity market performance. Inflows were light with €58m due only to managed accounts as ETFs continue to be showing outflows. Primary market picked up with 4 new issues totalling €1.3bn, bringing year-to-date supply issuance to €29bn (50% up y/y).

In M&A news, Adient, the world's largest car manufacturer, announced it is selling its Chinese JV business for $1.4bn, which will be used for debt reduction, supporting the focus on deleveraging. Rolls Royce put on hold the sale of its Bergen unit due to concerns it could put Norway's security interests at risk. The sale was expected to raise €150m so only a small part of the group's £2bn disposal plan.

Leveraged loans

Leveraged loan prices were slightly lower as well over the week. The average price of the J.P. Morgan Leveraged Loan index declined $0.01 to $98.31. The asset class remained in favour, however, reporting its 9th consecutive weekly inflow with a $528m contribution.

Structured credit

The Agency RMBS market outperformed the broader investment grade bond market once again last week.

The sector was down 19bps vs the Bloomberg Barclays US Aggregate Bond Index, which fell 43bps. Valuations on production coupons are stretched by most metrics as supply < demand driven by continued Fed purchases of $40bn a month. Higher rates have extended mortgage duration and reduced prepays with the universe of refi-eligible mortgages declining to 60% from 80% a month ago. Housing fundamentals remain strong with 5% of mortgage borrowers past due on payments. Spreads are tight in non-Agency RMBS but the momentum for further tightening has slowed. In CMBS, the spread curve flattened with AAAs leaking wider and conduit mezz strengthening on investor on opportunistic trading. With US states being urged to provide universal vaccine eligibility by 1 May 2021, the timeline for re-opening is becoming more certain.

Municipals

Despite selling pressure on US treasuries and an upward shift in rates, municipals experienced no such strain.

Week-over-week muni yields were lower between 5-10bps across the AAA curve, leaving yields lower by 10-15bps on the month. The Bloomberg Barclays Municipal Bond Index has returned +0.72% month-to-date, edging closer back towards positive territory for the year at -0.24%. Lower quality has fared much better as high yield munis are +0.90% month-to-date and remain positive for the year at +1.93%. Similarly, the lower rungs of the investment grade market, both A-rated and BBB-rated segments, remain positive for the year at +0.10% and +1.12%.

Primary deals have been met with solid investor demand; most were oversubscribed and repriced lower then traded strongly in the secondary. Through last week, Lipper reported year-to-date inflows of $29.3bn into municipal funds. The visible supply calendar for the coming week is the largest we've seen so far in 2021, so market participants will pay close attention to fund flow data, as continued inflows will be necessary to absorb higher supply. With the relative outperformance versus treasuries, AAA muni/treasury yield ratios are back in rich territory; 2-years at 60%; 5-years at 51%; and 10-year / 30-year ratios at 63% and 69% respectively. Recent passage of the $1.9trn stimulus bill, which includes $350bn for state and local governments should be supportive of improving credit fundamentals, meaning lower quality segments of the market could continue to gravitate back towards pre-covid spread levels.

Asia fixed income

JD.com's Q4 operating results were solid with net revenue of CNY224.3bn (+31.4% y/y), driven by the revenue growth at JD Retail (+27.9% y/y to CNY208.6bn). The revenue in general merchandise, electronics, home appliances and advertising drove the solid Q4 performance. Cash balance including restricted cash and short-term investments rose to CNY151.1bn ($23.2bn), more than doubling y/y, thanks to strong fee cash flow generation, its secondary listing at the Hong Kong stock exchange, the IPO of JD Health and other fund-raising activities (preference share financing of JD Health and bond issuance for JD.com).

The PBOC has approved the $1.5bn swap line with Sri Lanka. According to the State Minister from Money and Capital Markets, Sri Lanka will keep the swap line as a buffer that could be drawn down as needed. The IMF had earlier received a request from Sri Lanka for emergency financial support due to the pandemic. However, both parties did not come to an agreement about the key requirements for the IMF financial support such as debt sustainability matters. The last IMF programme for Sri Lanka was the $1.5bn 'extended fund facility', which commenced in 2016 and expired in June 2020.

Vedanta Resources Ltd is waiting for the SEC approval to commence its voluntary open offer to buy additional stakes in Vedanta Ltd. The Vedanta Ltd shares are listed as American Depositary Receipts on the NYSE. Vedanta Resources has already received the approval from the Securities and Exchange Board of India on 22 February.

Emerging markets

The hard currency index tightened 6bps on the week. Corporate spreads, which have been more resilient recently, tightened 2bps. The local index returned 0.47% in US dollar terms.

In Brazil, February inflation rose to 5.2%, significantly overshooting the country's 3.75% target. The central bank is expected to hike rates 50bps to 2.50% in response. In Brazilian politics, former president Lula was cleared of corruption charges and is now free to run in the upcoming election. On the macro front, both China's industrial production and retail sales beat expectations growing by 35.1% and 33.8% respectively year-on-year. The figures are distorted by the low base of 2020; however, industrial production was still up 17% y/y from 2019 levels.

Commodities

The commodity index was flat over last week. Year-to-date returns stand at 10.1%.

WTI and brent delivered a small negative return following the recent rally. Despite higher oil prices, the US rig count fell by 1, to 402 last week; this compares to almost 800 this time last year. This is because of the high initial investment, hefty ongoing maintenance costs and limited operational life associated with US shale production.

In agriculture, both soybean oil (+6.9%) and palm oil (+6.8%) rallied. This has been driven by supply shortages as a result of the push for enhanced biofuel production.

Responsible investments

Last week we saw the launch of the Sustainable Finance Disclosure Regulation (SFDR), which took effect for all EU financial market participants and advisers. Asset managers will need to start disclosing numerous ESG data and reporting to determine how green their portfolios are, a move the EU is hoping will help steer more capital into sustainable outcomes. Part of the regulations allow portfolios to be classified depending on how their aims and objectives relate to ESG investing.

Pandemic bond issuance (bonds with use of proceeds going direct to fund healthcare efforts and other pandemic related support) is now $30.7bn year-to-date after a further $10.7bn was issued by the EU last week.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

15th March 2021

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	▪ 2021 data is shaping up to be noisy once again, but in a much different way than 2020. This time, growth is going to be robust, especially in the US. In addition, issuers on the whole are coming into this environment better than they went into the pandemic. ▪ Valuations in most areas of credit provide much less cushion for volatility. But compared to similar spread levels in the decelerating global economy pre-COVID, we still prefer to carry more credit risk in today's accelerating economy. ▪ Question marks on the sustainability of super easy financial conditions, inflation, & the labour market widen the range of outcomes for spreads in one year's time.	▪ Rapidly rising Treasury yields tighten financial conditions or make all in yields of credit less attractive. ▪ A recovering economy propels spreads to all-time tights, especially if vaccinations accelerate quickly ▪ Geopolitical tensions rise above a simmer, particularly in the US China relationship, which has not meaningfully improved with a new US Administration.
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long £ €	▪ Pandemic scarring likely to keep growth subdued ▪ Reflation credibility still low, although risks from fiscal policy ▪ 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	▪ 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$ $	▪ 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	▪ The long leash markets gave EMs in 2020 is not extending into 2021. Questions about fiscal stability are rising again (see Brazil). ▪ Index composition changes over the last 5 years have added a lot of duration to the sector, leaving it vulnerable. ▪ US growth outperformance is starting to cause weakness in EMFX, and financial conditions for EMs is tightening.	▪ 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	▪ Index spreads are back to pre-COVID levels, but the duration of US indices have also lengthened by ~10%. ▪ Issuer balance sheets still look remarkably strong, and cash reserves remain very high. Our base case is that a fair amount of deleveraging can occur with this cash, but as the economic recovery accelerates and COVID moves to the rear-view mirror, the spectre of M&A and shareholder return still looms. ▪ IG has been historically resilient in the face of inflation, even if other sectors may benefit more from it.	▪ 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 inside LT averages, even adjusting for the better quality of today's index. But spreads are still wider than pre-COVID. ▪ Access to capital remains easy even through more volatile markets of late, and a return to normalcy disproportionately benefits low-quality credits. ▪ 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, 2020's downgrade cycle turns quickly into an upgrade cycle. ▪ 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 ▪ Duration in the sector is now rising quickly as mortgage rates move higher.	▪ 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 continues to outperform in the recovery as HH balance sheets are strong, demographics are positive, and supply is constrained. Valuations are less compelling, but pockets of value still exist. ▪ CMBS: a return to normalcy won't look 'normal' for sectors like office space or convention hotels, but pockets of value still exist in these and other areas (but there are simply fewer opportunities than 6 months ago) ▪ Our preference remains for non-agency RMBS in this area.	▪ Changes in consumer behavior 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, butseems unlikely to derail it.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper vs Aluminium ▪ o/w Lead vs Zinc ▪ o/w Soybeans ▪ u/w Sugar ▪ u/w Livestock	▪ US China trade war

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