COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

1 NOVEMBER 2021

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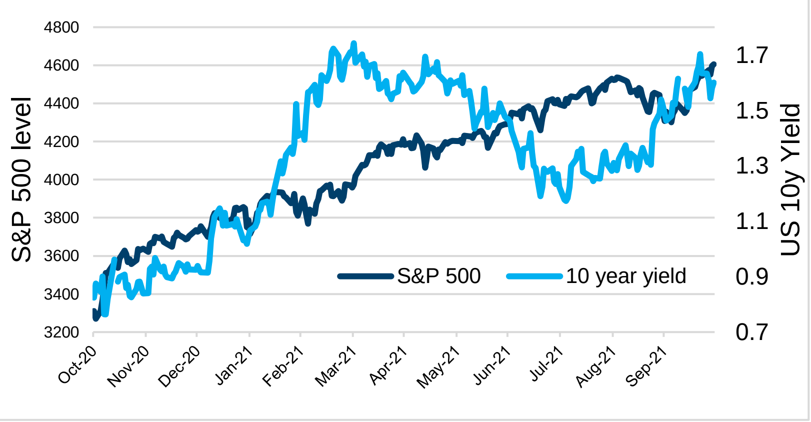
Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	1.58%	-5 bps	0.0%	-2.7%
German Bund 10 year	-0.09%	1 bps	0.1%	-2.8%
UK Gilt 10 year	1.08%	-7 bps	2.3%	-5.6%
Japan 10 year	0.10%	0 bps	-0.1%	-0.2%
Global Investment Grade	92 bps	1 bps	-0.1%	-1.0%
Euro Investment Grade	88 bps	1 bps	-0.7%	-1.1%
US Investment Grade	89 bps	0 bps	0.2%	-0.9%
UK Investment Grade	90 bps	1 bps	0.4%	-3.0%
Asia Investment Grade	188 bps	-4 bps	-0.5%	-0.5%
Euro High Yield	331 bps	3 bps	-0.6%	3.0%
US High Yield	315 bps	8 bps	-0.2%	4.5%
Asia High Yield	818 bps	21 bps	-6.3%	-12.1%
EM Sovereign	327 bps	2 bps	0.1%	-1.5%
EM Local	5.6%	4 bps	-1.3%	-7.6%
EM Corporate	300 bps	0 bps	-0.5%	1.1%
Bloomberg Barclays US Munis	1.2%	-1 bps	-0.3%	0.5%
Taxable Munis	2.3%	-7 bps	0.8%	1.6%
Bloomberg Barclays US MBS	24 bps	0 bps	-0.2%	-0.9%
Bloomberg Commodity Index	221.35	-0.4%	2.6%	32.5%
EUR	1.1569	-0.7%	-0.2%	-5.4%
JPY	114.26	-0.5%	-2.4%	-9.4%
GBP	1.3656	-0.5%	1.5%	0.1%

Source: Bloomberg, Merrill Lynch, as at 1 November 2021.

Chart of the week: S&P 500 & US 10-year yield – LTM



Source: Bloomberg, Columbia Threadneedle Investments, as at 29 October 2021.

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Commodities
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Macro / government bonds

US equities printed a new high as we end October while bonds remain mired in volatility with yields near their highs for the last 12 months – **see chart of the week**. Meanwhile, risk markets in fixed income are locked firmly in a tight range, even though areas such as energy and autos and riskier bank debt (eg, Cocos) have outperformed on a risk-adjusted (percentage) basis. So certainly, a year to have avoided risk-free assets and placed your bets elsewhere.

The last week of October brought a change in direction for government bonds and a sharp flattening in the yield curve. As an example, the 20–30-year curve inverted in the US. Overall yields are still higher in October, however, but below the peak set in March and mid-October. The short end of yield curves is being driven higher by fears of rising interest rates while the long end has been supported by a stabilisation in inflation expectations.

Growth estimates and data are more mixed, influenced in part by supply disruptions (eg, microchip shortages for the auto sector). As an example, Germany lowered its forecast for 2021 growth to 2.6% from 3.5%. From forecast to reality. US GDP came in at 2.0% for Q3, below an expected 2.6% (and a 7% expectation as recently as August 2021). The core PCE deflator rose at an annual 4.5% rate in line with consensus. Growth was reduced by a weak consumption number of just 1.6% (this was 12% in Q2). Supply chain shortages were noted in car purchases. The US Employment Costs exceeded expectations at 1.5% q/q.

The European Central Bank met last week seeking to sooth some of these inflation and interest rate fears. It noted that market implied rate changes (rate rise by early Q4, 2022) are not consistent with the central bank's own forecasts. The ECB suggested that inflation would ease through 2022 and that the PEPP programme would end in March of next year. Did its rhetoric have the desired effect? Not really! If the barometer of interest rate fears is the two-year German government bond, then a new 'high' in yield (highest since early 2020) indicates that fears increased, or that its messaging disappointed markets. Eurozone GDP outperformed expectations coming in at 2.2% q/q (expected 2.1% and 2.1% in Q2, 2021) Inflation also exceeded forecasts at 4.1% y/y (expected 3.7%) with the core rate at 2.1% y/y.

At last week's UK budget, the Chancellor spent only around half of the benefit he received from upgraded and improved economic forecasts. This reflects a desire to be able to reduce the tax burden ahead of the next general election. The UK economy still faces tighter fiscal policy next year including increased personal and corporate tax rates.

This week brings central bank meetings in the UK where a rate hike hangs in the balance and the US where we should hear of plans to taper asset purchases on government and mortgage bonds. The market is pricing two rate hikes next year. Friday also sees the US employment report where a growth of 425k jobs in the market is the consensus (after 194k last month) and a decline in the unemployment rate is forecast at 4.7%.

Investment grade credit

I feel like we write the same thing every week. Corporate bond spreads were little moved last week. For the month of October, the spread range was only 3bps for the ICE BoML Global IG index.
As it stands, valuations are expensive relative to short and long-term averages; and to that extent the market appears fairly fully valued.

We continue to wade through what has been a relatively strong earnings season. Stronger results from Coca Cola, Holcim, McDonalds, WPP (cyclical recovery in advertising spend) and Microsoft (growth in Cloud) were obvious examples, though Boeing missed expectations.

Banks results in Europe also continue along an improving trend with higher profitability, driven by write backs. Capital ratios are high (and increasing in places), though are unlikely to improve further from here with gains directed towards shareholders. This feature has already been a pronounced dynamic in the US where capital ratios have now fallen as a result. Residential lending continues to be a bright spot in Europe in terms of lending as does investment banking, especially in the equity business. As we are in reporting season, issuance is relatively limited, providing a seasonal, technically supportive background for the market.

In other specific news, we should be able to welcome Netflix to the investment grade world soon as it was upgraded by S&P to BBB last week (for context this company was rated as lowly as BB- as recently as 2019). The benchmark 2030 dated US dollar bonds trade with a spread of around 95bps over government bonds, a significant improvement on a spread of 308bps two years ago, at issue. Credit improvement indeed!

High yield credit

US high yield bond spreads remained in a tight range over the past week amid limited earnings misses, relatively light primary activity, a second straight large retail inflow, and significant yield curve flattening as markets price in an earlier start to global monetary tightening. The ICE BofA US HY CP Constrained index returned 0.6% and spreads were 2bps wider over the week. According to Lipper, the asset class posted another $1.2bn inflow despite rate volatility, with each of the past two weekly inflows the largest since April.

The European market was little changed last week but posted a modest negative return for the month of October. It has been a busy period for primary market / new issuance. Notable issuers last week included Asda the UK supermarket chain and Arrow a speciality Finance business. As mentioned in the investment grade section, Netflix was upgraded and left the ICE BoAML index at end of October. The inflation discussed in the macro section is being evidenced in results but most of these price rises are being passed through to consumers.

Leveraged loans

Leveraged loan prices drifted $0.05 lower over the past week on muted price action amid lighter issuance and a quiet start to Q3 earnings season. While performance for loans has moderated, the product has still managed to post positive total returns in each of the past 13 weeks. For context, US high yield bonds have posted negative total returns in five of the past six weeks. Notably, despite falling $0.05 over the past week, prices are only $0.09 below the year-to-date high. Asset class inflows continued with a $706m contribution over the week.

Structured credit

The US Agency MBS market was up 28bps on the week on the rally in rates and positive news in forbearance exits. Black Knight reported the largest one week drop in mortgages in forbearance in the past 12 months with active forbearance contracts at 1.25m. The most significant form of exit are borrowers either curing by coming current or paying off in full. This week all eyes will be focused on the FOMC's expected taper announcement. In CMBS, the delinquency rate declined for the

16th consecutive month to 5.1% and modifications stand at 6.9%. Spreads last week were range-bound in higher quality CMBS while below-IG paper was tighter. October SASB volumes were up 33% versus the year-to-date monthly average and CMBX risk was weaker on the month.

Asian credit

Evergrande Group has paid the overdue coupon ($45.2m) on its EVERRE 9.5% ‘24s just before the 30-day grace period ended on 29 October. By paying the coupon within the grace period, Evergrande is fending off defaults and potentially buying time ahead of debt restructuring. The company faces another wall of coupon payment over the coming weeks. There are three overdue coupon payments ($148.2m) on three EVERRE bonds, for which the grace period ends on 10 November 2021. Furthermore, on 6 November 2021, there are coupon payments ($82.5m) for two TIANHL bonds.

Adani Ports & Special Economic Zone (APSEZ) announced that following the review by its risk management committee, the company has decided to exit its investment in Myanmar. APSEZ will explore divestment opportunities which it expects to conclude by March–June 2022. The company is also interested in buying the 30% stake in Container Corporation of India (Concor), which the Government of India is selling. APSEZ plans to manage any acquisitions without jeopardizing its Investment grade ratings.

Emerging markets

On the covid front, vaccinations have picked up across emerging markets. Among the BRICS, China leads in vaccinations with 74% of the population fully vaccinated, with India and South Africa lagging at 24% and 20% respectively. Speaking at the G20 summit; Indian prime minister Modi said India is ready to produce 5 billion covid vaccinations in 2022.

Peru came to market with $4bn of bond issuance, the nation’s first issue since leftist Castillo became president. This included two sustainable issues; a $2.25bn 12-year and a $1bn 2072 maturity issue. Castillo also called for constitutional changes and is looking to nationalise one of Peru’s largest gas fields. Despite recent downgrades, Peru hold South America’s second highest credit rating at Baa1.

Commodities

Aluminium prices fell by 5.3% on the week as previously announced production cuts from Glencore have yet to materialise. Elsewhere at the G20 summit in Rome the US and EU announced a deal to ease steel and aluminium tariffs. The US will allow limited volumes of tariff free steel and aluminium imports and the EU will drop retaliatory tariffs on the US.

Natural gas fell -0.6% on the week, including a 5.8% drop on Friday. The drop was driven by milder weather forecasts for the US west coast and mid-west. In Europe, Germany announced Nord Stream 2 wouldn’t pose any risks to security or supply. However, as of Monday European gas prices rallied as Russian natural gas shipments to a key German compressor station dropped to zero and even reversed direction.

Responsible investments

New regulations from the UK starting next year, will require the country's largest companies to report on climate related risks. Companies with at least 500 employees and an annual revenue of £500m, will have to report on climate-linked financial information in the new tax year (April 2021).

According to a Brazilian climate report, emissions rose 9.5% versus 2019 in Brazil for 2020. The report states this was due to further deforestation in areas such as the Amazon. Deforestation along with agriculture and livestock accounted for around 70% of the total domestic gas emissions. Brazil sits among the top carbon emitters in the world. President Jair Bolsonaro is due to release plans of their net-zero target at the COP26 event.

Last week, Hertz Global announced it was buying 100,000 Teslas in its first move towards electrifying its rental car fleet. Just four months after the Hertz came out of bankruptcy, this purchase enabled Telsa's share price to surge 4.8% in premarket trading and carried the value past $1trn for the first time.

Finally, this week kicks off climate talks in Glasgow, hosted by the UK Prime Minister. The COP26 summit has been a long-awaited climate event and has bought world leaders and climate experts together to discuss and agree on what needs to happen to slow the rise in global temperatures.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views
1st November 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	▪ The worsening Delta variant is threatening global reopening/growth stories as case counts rise and restrictions return. In areas with high vaccination rates, low mortality rates may deter policy moves. ▪ Although credit spreads have widened slightly, they are still near all time tights and leave little room for the growth story to get derailed. Pockets of opportunity with deleveraging & upgrade activity exist. ▪ We are past the peak of central bank accommodation. The pullback in liquidity won't be aggressive, but it leaves opportunity for market volatility. ▪ Uncertainty is rising as Delta threatens the recovery, monetary & direct fiscal support wane, and unemployment benefits expire.	▪ Upside risks: the unique COVID recovery in fundamentals allow spreads to rocket past all-time tights. Spreads have spent extended periods near tights in other periods as well. ▪ Downside risks Delta variant cases worsen and restrictions return, threatening returns to schools, offices and travel Once spreads hit these extreme levels, future returns are rarely good Both fiscal and monetary stimulus are removed just as growth decelerates could cause a sell off
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long £ €	▪ Yields have broken out of their earlier tight ranges but likely to remain capped by structural downtrend in real yields and growth ▪ Pandemic scarring keeps reflation credibility low ▪ 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	▪ Inflation becomes more persistently entrenched, warranting much higher rate structure ▪ 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$ $	▪ The US leads the way on the economic recovery from the pandemic, which drives a monetary wedge between the Federal Reserve and ECB ▪ Window for dollar underperformance has narrowed as central banks globally turn more hawkish on inflation expectations at the expense of growth	▪ Re-acceleration of global growth forecasts led by reversal of China credit contraction ▪ US fiscal push fades
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	▪ Selective opportunities ▪ Dollar resilience may crimp scope for EMFX performance ▪ EM real interest rates relatively attractive, curves steep in places	▪ Central banks tighten aggressively to counter fx weakness ▪ EM inflation resurgence ▪ EM funding crises drive curves higher and steeper ▪ Tightening global financing conditions
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Dispersion in outlooks across EM is rising as the recovery begins at different paces. Countries with commodity exposure and better fiscal adaptability rise to the top. ▪ Index composition changes over the last 5 years have added a lot of duration to the sector, leaving especially IG EM vulnerable. We prefer HY EM (selectively). ▪ US growth outperformance is starting to cause weakness in EMFX, with the exception of countries aggressively hiking rates (like Russia and Brazil).	▪ 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. ▪ There are even further delays in mass vaccination outside of developed markets.
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ US spreads are the tightest since 2005, when average credit quality was higher and duration was 50% lower. ▪ IG has been historically resilient in the face of inflation, even if other sectors may benefit more from it. ▪ Good fundamentals after most recent earnings, with strong balance sheet management and deleveraging from capital management & sales growth	▪ 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 nearly to all-time tights, although credit quality has improved through defaults and ample liquidity ▪ The best performing parts of these sectors have been the most volatile and lowest quality. ▪ Defaults are set to drop dramatically in 2021 in part due to the rapid recovery, but also due to an ability to remove near-term maturities by companies across the credit spectrum.	▪ The reach for yield continues to suppress spreads. ▪ Waves of ratings upgrade begin to occur this year. ▪ There are few exogenous shocks that shake the tight spread environment.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ The Fed has been the 1000lb gorilla in this market since COVID hit, and it is progressively getting closer to tapering. The Fed will taper MBS alongside USTs, but tapering will still be a headwind to the market. Banks, the other major buyers, have slowed their purchases as well. ▪ With interest rates falling again, fundamentals worsen as prepayment speed will remain elevated. Changes to FHFA housing policies could also be marginally negative for fundamentals over time.	▪ 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. ▪ The Fed maintains or increases MBS purchases next year.
Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Our preference remains for non-agency RMBS in this area. ▪ 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 can provide stable carry in de risking portfolios. ▪ CMBS: favored bonds are still 'story' bonds. A return to normal won't look 'normal' for sectors like office space or convention hotels and recently has lagged. ▪ Spread tightening looks somewhat excessive along the margins of credit quality.	▪ Changes in consumer behaviour 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, but seems unlikely to derail it.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper & Lead vs Zinc ▪ u/w Livestock ▪ u/w Gold ▪ o/w Soybeans ▪ o/w Oil	▪ US China trade war ▪ Renewed Covid lockdowns ▪ Global Recession