INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

28 FEBRUARY 2022

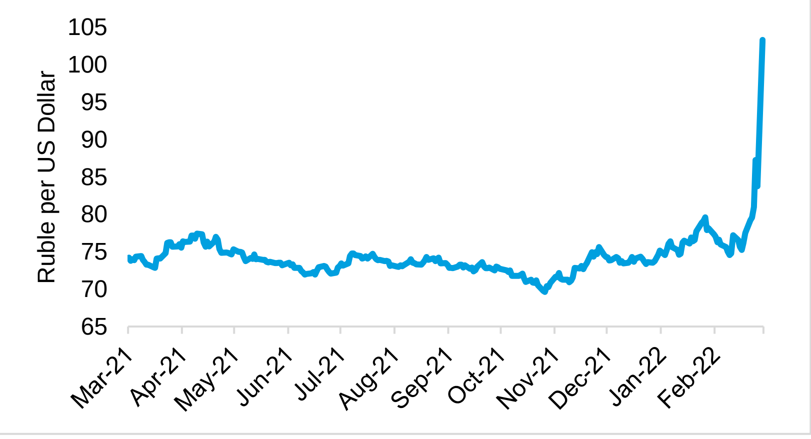
Conflict comes to Ukraine.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	1.90%	-3 bps	-1.7%	-3.5%
German Bund 10 year	0.17%	-2 bps	-1.8%	-2.9%
UK Gilt 10 year	1.44%	6 bps	-1.8%	-5.8%
Japan 10 year	0.19%	-2 bps	-0.8%	-1.6%
Global Investment Grade	131 bps	8 bps	-2.9%	-5.4%
Euro Investment Grade	141 bps	14 bps	-2.8%	-4.1%
US Investment Grade	127 bps	7 bps	-3.1%	-6.1%
UK Investment Grade	120 bps	6 bps	-2.4%	-5.2%
Asia Investment Grade	207 bps	9 bps	-1.6%	-3.2%
Euro High Yield	433 bps	22 bps	-2.8%	-4.2%
US High Yield	362 bps	-16 bps	-1.1%	-3.9%
Asia High Yield	799 bps	55 bps	-4.0%	-7.8%
EM Sovereign	379 bps	24 bps	-4.0%	-6.8%
EM Local	6.2%	25 bps	-0.5%	-0.5%
EM Corporate	362 bps	32 bps	-3.6%	-5.2%
Bloomberg Barclays US Munis	1.9%	-3 bps	-0.4%	-3.2%
Taxable Munis	2.9%	7 bps	-2.5%	-5.6%
Bloomberg Barclays US MBS	27 bps	-1 bps	-1.5%	-3.0%
Bloomberg Commodity Index	245.77	0.7%	4.2%	13.4%
EUR	1.1174	-0.5%	0.3%	-0.9%
JPY	115.57	-0.4%	-0.3%	-0.3%
GBP	1.3375	-1.3%	-0.3%	-0.9%

Source: Bloomberg, Merrill Lynch, as at 28 February 2022.

Chart of the week: Russian Ruble / US Dollar LTM



Source: ICE BoML, Bloomberg, Columbia Threadneedle Investments, as at 28 February 2022.

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Emerging Markets

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Macro / government bonds

What a year it has been for financial markets: and not in a good way. Investors have had to deal with rising inflation expectations, the fear of monetary policy recalibration, increasing real yields (and discount rates), a new iteration of the pandemic and most recently simmering geopolitical tensions that became outright conflict between Russia and Ukraine. This means after years of strong returns asset markets are virtually all in negative return territory for 2022.

Last week the focus was on Russia's recognition of Donetsk and Luhansk as separate states and its invasion of Ukraine. This aggression prompted a series of responses from Europe, the US and elsewhere perhaps the most significant of which was that the Nord stream 2 pipeline, which was meant to transport Russia gas to Europe, was put 'on hold' and several Russia banks were excluded from the SWIFT payment system. In response the central bank of Russia doubled interest rates to 20%. Russia's ally Belarus also raised rates.

Government bond yields rallied in the face of declines in equity prices and a widening in credit spreads. By the start of this week yields were a few basis points lower in the US week-on-week.
Economic data was of less importance, though US consumer confidence dipped to a five-month low while the composite PMI data out of both Europe and the US was robust especially in the service sector. At the end of the week key personal consumption expenditure inflation data showed that inflation was at 5.2% y/y and the highest since the early 1980s. The yield curve continues to flatten as shorter dated, more interest rate sensitive bonds underperform their longer maturity cousins. The difference between 2 year and 10-year bonds has fallen to below 40bps; a move to an inverted curve where longer maturity bonds offer less yield than shorter term bonds is often considered a lead indicator of impending recession. We are not there yet!

Investment grade credit

If it has been tough for government bonds this year, it has been worse for investment grade credit. Excess returns (to governmnet bonds) are deeply in negative territory and YTD total returns are the worst (annual) since index data commenced in 1996. This year's cocktail of rising government bond yields with widening corporate bond spreads is a corrosive mix.

The good news from a valuation perspective is that spreads are no longer expensive, compared to either short or long-term averages while yields have almost doubled this year. Are we comparing 'apples with apples' though? The duration of the global index (according to data from ICE BoML), which was less than five years before the Global Financial Crisis has increased to around seven years today. Meanwhile, the average rating of the index has fallen from an A1 composite rating to A3 over the same period. So, more interest rate risk and a lower credit rating. Our view remains balanced for credit market spreads directionally from here. As mentioned, valuations look more appealing, though hardly cheap. Meanwhile, the unwind of supportive monetary policy conditions warrants attention, especially were central banks to seek to move interest rates into contraction at territory. Corporate results and expected corporate health continue to be healthy with the commodity/energy super cycle supporting materials and energy companies and economy lifting more cyclical businesses. Banks too seem to be enjoying a benign credit environment, rising margins, falling 'cost of risk' and relatively healthy investment banking conditions all the while with healthy capital ratios.

In specific news, BP is seeking to sell its holding in Russian oil company Rosneft (c.20% stake) and the Norwegian Sovereign Wealth fund appears to be divesting of its Russian assets as well.

High yield credit & leveraged loans

Following a significant repricing in response to a hawkish Fed to begin 2022, US high yield bonds were relatively stable despite volatility in equities and commodities over the past week as investors attempt to assess the economic implications of Russia's decision to order a military attack on Ukraine. The ICE BofA US HY CP Constrained Index returned 0.44% and spreads were 16bps tighter. According to Lipper, the asset class experienced a $996m outflow, leaving YTD outflows at nearly $19bn. Despite a late-week bounce alongside broader markets, leveraged loans endured their largest weekly decline since October 2020 as their relative resiliency in 2022 faded amid an escalation in geopolitical tensions. The average price of the J.P. Morgan Leveraged Loan Index declined $0.47 over the week to $97.60 and is now $1.35 below the 2022 high. Inflows to leveraged loans continued with a $913m contribution over the week. However, this was lowest inflow over the last seven weeks. YTD inflows to the asset class total more than $15bn.

European high yield sold off last week as risk assets were impacted by the Russian/Ukraine crisis. Liquidity was poor with wider bid-offer spreads given the volatility of the market. Outflows continued though were modest compared to previous weeks and did not yet include any sales that may have occurred after the Russian invasion of Ukraine. Shortening maturity trading was seen; the primary market was shut as issuers continued to hold off bringing new issues due to the market volatility.

Given the geopolitical situation, the market focused on Russian exposures. Renault was shown to have one of the largest exposures as Russia is its second largest market, through its holding in Avtovaz, which produces Lada and Zhiguli as well as auto parts. Avtovaz is 6% of sales and was 13% of FY21. Sanctions are likely to have a negative impact, similar to the chip shortages effect.

Asian credit

Alibaba's Q3 operating results show that the company's domestic commerce business is seeing more macro headwind and higher competition. While the company's consolidated revenue rose to CNY252.6bn (+20.9% q/q, +9.7% y/y), its customer management revenue fell 1% to CNY100bn due to the macro slowdown, tougher competition and incentives given to merchants to adopt new value-added services. Its balance sheet remained strong with cash and short-term investment of CNY478bn compared with total debt of CNY139.6bn. The National Audit Office and China Banking Insurance Regulatory Commission (CBIRC) have directed banks and SOEs to report their exposure to Ant Group (32.75%-owned by Alibaba) and this led to further concerns about more potential regulatory measures in the consumer internet sector.

Economic Daily (a China-run newspaper) stated that the market has overreacted to the government's guidance that food delivery platforms should lower their service fees. This is related to the document released by fourteen ministries and regulator (including the NDRC, National Development and Reform Commission) on 18 February, which contain guidelines to support the recovery of services industries, with an emphasis on sectors that are significantly hit by the pandemic. While the document was not specifically targeted at the food delivery companies such as Meituan and Ele.me (owned by Alibaba), there was a statement that encourages the food delivery platforms to lower their service fees.

Emerging markets

In response to the invasion of Ukraine the US, UK, Europe and allies will now exclude several Russian banks from the SWIFT payment system. Critically this will likely make the functioning of Russia's financial system incredibly difficult, while a former Russian finance minister has suggested this could cost Russia a 5% loss of GDP. From a European standpoint this will likely make the importing critical supplies of natural gas more difficult.

In response to sanctions the Russian Ruble is now down 26% YTD **(see chart of the week)**. Russia's stock index (MOEX) is down 29% since Valentine's Day. To make matters worse Russian sovereign bonds were downgraded to high yield by Moody's and S&P have placed them on a negative outlook. In response, Russia's central bank raised its interest rate by 10.5% to 20% and has imposed restrictions on the flow of capital, including banning foreigners selling Russian securities. Russian exporters of energy and metals were also ordered to sell 80% of their foreign exchange reserves to support the Ruble.

In China, US dollar bonds continued selling off due to global market volatility and expectations of a housing slump within China. In more positive news, developer Modern Land has reached a restructuring agreement with creditors. Elsewhere, major banks in the city of Nantong have slashed the down payment ratio by 10% to 20%. In central bank news Hungary raised interest rates a further 50bps to 3.4%; Belarus also hiked by 2.75% to 12%; and South Korea held rates at 1.25%.

Commodities

Oil prices rallied last week, with Brent up 3%. Prices surged as high as $105 but moderated on Friday boosted by lighter touch sanctions and the news of proposed talks between Ukraine and Belarus. Brent is rallying as of this morning following the news of Russian banks being cut from the SWIFT payment system.

Aluminium prices also rose 3% on the week. The increase can be attributed to Russia's role in producing 6% of the world's supply, higher energy prices also drive up the cost of aluminium given the highly energy-intensive electrolysis process by which aluminium is made. Wheat rallied 6.9% due to the conflict in Ukraine. Gold declined by 0.6% last week; however, is up 3.1% YTD. Despite being heralded as "digital gold" bitcoin is down from $46,000 to $38,000 since the start of 2022.

Responsible investments

After a windy week in Europe, it's not surprising to find out that a record amount of wind power was produced across the continent. This did provide some relief to those nations who are reliant on out-of-state fossil fuels, but not quite the reassurance needed given the energy crunch and conflict between Russia and Ukraine.

As March begins tomorrow, it seems we've only just about hit around half as much new specific use of proceeds issuance for this month compared to January ($114bn was issued in January versus $53bn so far for February, according to Bloomberg). It seems this is due to the lack of Social and Sustainability bond issuance we've seen in previous weeks; however, Green bond issuance is very much in line with previous months. Some market players still stand by their predictions of another record-breaking year of issuance. We'll have to wait and see what March brings.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views
28th February 2022

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	▪ 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 economic growth, with high expectations for tightening at March FOMC. The pullback in forecasted liquidity has left opportunity for market volatility. ▪ Uncertainty remains elevated as the Omicron variant spreads, inflation fears revive, supply disruptions continue, 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: Omicron worsens. Supply chain disruptions and inflation persist to H2 2022. Simultaneous low unemployment, hiking and slowing growth could cause a sell off or recession.
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long £ €	▪ Carry offered by front end yields now attractive ▪ Longer yields continue to be capped by long-run structural downtrends in real yields ▪ Inflation likely to normalize over medium term ▪ Hiking cycles to be shortened by easing inflation and moderating demand	▪ Inflationary dynamics become structurally persistent ▪ Labour supply shortage persists; wage pressure becomes broad and sustained ▪ Fiscal expansion requires wider term premium ▪ Long run trend in safe asset demand reverses
Currency ('E' = European Economic Area)	¥ EM A$ Short -2 -1 0 +1 +2 Long £ $ E	▪ The potential for an end to negative rates in the eurozone is significant for the Euro given non-linearities around the zero bound ▪ Experience of past cycles suggests the Dollar fares less well at the start of a cycle, turn neutral USD for now	▪ ECB concludes no risk of second round inflation effects and leaves policy on hold ▪ BoE meets lofty market expectations for hikes
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	▪ Russia/Ukraine conflict cautions against aggressive positioning ▪ Aggressive Fed pricing may now open the door to selective EMFX performance ▪ EM real interest rates relatively attractive, curves steep in places	▪ Negative sentiment shock to EM fund flows ▪ 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	▪ Valuations are getting more attractive, although for reason ▪ DM tightening financial conditions will unevenly impact EM credit and EMFX as many countries have already responded to inflation through hikes ▪ 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).	▪ Spillover from China's credit woes or Russia-Ukraine aggression ▪ 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 DM
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.2021 Q3 earnings supported this, now looking to Q4 results. ▪ Good fundamentals, with strong balance sheet management, M&A 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 enhancing activities pick up, but most are leverage neutral.
High Yield Bonds and Bank Loans	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 Runway left in HY recovery trade rising stars ▪ Bank loans are attractive as they have shown better performance relative to corporates, although flows amid hiking expectations have increased valuations ▪ The best performing parts of these sectors have been the most volatile and lowest quality. ▪ Defaults are set to continue near historic lows due to the rapid recovery and ability to remove near-term maturities by companies across the credit spectrum.	▪ The reach for yield continues to suppress spreads, although mounting negative headwinds (inflation, supply disruptions) are increasing pressure for higher yields. ▪ Waves of ratings upgrade begin to occur into this year. ▪ There are few exogenous shocks that shake the tight spread environment.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Overall, the risk/reward mix remains asymmetric. ▪ Valuations continue to widen on hawkish language; however, valuations remain rich and carry in many Specified Pools and CMO deals remain unattractive. ▪ Spreads still tight to similar Fed taper and QT regimes ▪ The Fed's taper was well advertised and saw a muted market reaction upon official announcement.	▪ Housing activity slows considerably and prepays move back down to normal levels, without denting households' ability to service mortgages. ▪ Uncertainty the Fed taper schedule and long-term position
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Our preference remains for Non-Agency RMBS and CLOs ▪ Spread tightening seems somewhat excessive per credit quality but seeing repricing risk premiums in new issues. ▪ Keeping an eye on sentinel slight upticks in defaults ▪ RMBS: Housing continues to outperform in the recovery with constrained supply and strong balance sheets & demographics. Affordability waning but near average. Anticipating more supply in 2022. Valuations less compelling but offer stable carry in de-risked portfolios. ▪ CMBS: Most segments maintain strong fundamentals with retail & hospitality improving. Spreads outperforming other structured segments. ▪ CLOs: Attractive with fundamentals, waiting for issue pickup	▪ Attractive shorter duration deals coming into market, provide less carry ▪ 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). ▪ SOFR transition slows CLO new issuance ▪ 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 Oil	▪ Renewed Covid lockdowns ▪ Global Recession

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