COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

8 MARCH 2021

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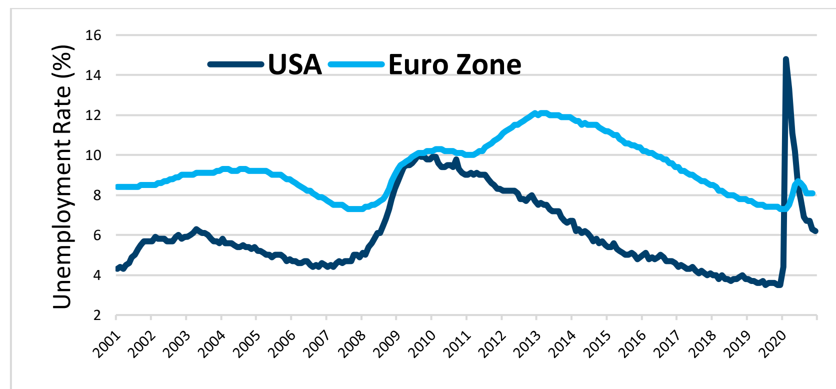
Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.59%	18 bps	-0.4%	-3.8%
German Bund 10 year	-0.29%	-3 bps	0.1%	-2.3%
UK Gilt 10 year	0.76%	-6 bps	0.9%	-6.6%
Japan 10 year	0.12%	-4 bps	0.7%	-0.4%
Global Investment Grade	98 bps	3 bps	-1.0%	-2.9%
Euro Investment Grade	89 bps	0 bps	0.2%	-0.7%
US Investment Grade	100 bps	5 bps	-0.9%	-4.0%
UK Investment Grade	92 bps	0 bps	0.3%	-3.5%
Asia Investment Grade	205 bps	0 bps	-0.1%	-0.6%
Euro High Yield	335 bps	1 bps	0.1%	1.1%
US High Yield	360 bps	8 bps	-0.2%	0.5%
Asia High Yield	559 bps	8 bps	-0.4%	0.2%
EM Sovereign	332 bps	4 bps	-0.9%	-4.6%
EM Local	4.8%	11 bps	-1.8%	-5.4%
EM Corporate	301 bps	1 bps	-0.3%	-0.5%
Bloomberg Barclays US Munis	1.2%	-6 bps	0.3%	-0.7%
Taxable Munis	2.4%	10 bps	-1.2%	-3.7%
Bloomberg Barclays US MBS	12 bps	-8 bps	-0.1%	-0.7%
Bloomberg Commodity Index	182.77	0.7%	0.7%	10.0%
EUR	1.1866	-1.3%	-1.3%	-2.5%
JPY	108.73	-1.7%	-1.7%	-4.7%
GBP	1.3846	-0.7%	-0.7%	1.3%

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

Chart of the week: Unemployment rates, Europe 2001-2021



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

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Macro / government bonds

Rising yields have been the key feature of the fixed income landscape this year.

As mentioned previously, this trend was borne out of rising inflation expectations and augmented by a nudge higher in real rates. If this latter rate is the key discount rate for risk markets such as equities, it helps explains why this market has been more volatile of late. Adding to the mix is the question of whether in a year of possibly double-digit nominal growth in the US, there is actually an economic necessity for the scale of fiscal stimulus being proposed or indeed ongoing ultra-low interest rates. The combination of these factors and the apparent successful roll-out of Covid vaccinations in the US and UK have combined in a difficult-to-digest cocktail for fixed income markets. Yields remain much higher than at the end December and returns for most areas of fixed income are in negative territory.

In terms of data last week, the focus was on employment markets. In February, the US unemployment rate fell to 6.2% **(see chart of the week)** in a month where there were 379k jobs created (exp 200k). This was boosted by a recovery in the leisure and hospitality sector. Economy wide, wages are also now growing at over 5%. In the eurozone, there was also better news in the jobs market. The unemployment rate came in unchanged at 8.1% (exp 8.3%) despite increased lockdowns in several countries. Elsewhere, the UK budget offered few surprises; corporate tax rates are set to rise though the Chancellor extended measures to support the economy while it remains in lockdown.

Investment grade credit

Credit spreads were little moved last week. Evidence of a clear relationship between changes in government bond yields and spreads is tenuous. Spreads were a little wider last week.

You might notice in the table at the back of this document that at a Fixed Income allocation level we have reined in our optimism about investment grade credit. As the text alludes to, this is largely driven by market valuations or spreads. The present level of global investment grade credit spreads is now around one standard deviation rich to a short term (5-year) average and over 0.5 standard deviations rich to the longer term (20-year) equivalent. It is important to note that on a time-weighted basis credit markets tend to trade inside these averages before spikes higher such as the GFC or Covid crises. There are also other ameliorating factors to consider, such as our expectation of improving credit quality, the rosier outlook for economies and of course the ongoing demand for income at a time of reduced primary issuance. Nonetheless, our assessment of market prospects is not as constructive as it was for most of the last 12 months.

Corporate results are coming reasonably robustly with issuers having (in general) a focus on deleverage. This is a trend we expect to continue through this year.

High yield credit

US high yield bond prices declined over the past week alongside a 20bps rise in the 10-Year US treasury yield to 1.60% and 3.4% loss for the NASDAQ as rising rates continue to spark a rotation. The ICE BofA US HY Cash Pay Constrained index returned -0.20% with spreads largely unchanged and yields 0.15% higher at 4.36%. Lower-quality issuers and the energy sector

continued to outperform. According to Lipper, the asset class reported a $600m inflow, which was largely ETF driven, leaving year-to-date net outflows at $3.7bn.

European high yield was basically unchanged as the market index spread moved only 1bps wider with CCC strongly outperforming BB and B. Hybrids were also weak last week; however, this did not reflect the overall volatility of the week as the market saw weakness in the first half on the general rates concern. This was especially the case for longer duration names. However, though the prevailing mood was one of “sell”, investors were still willing to step in and buy high quality names, returning the market to flat by the close of the week. Market outflows continued, this week rising to €654m between ETFs and managed funds and bringing year-to-date outflows to €2bn.

Good news on the credit rating from as CMA, this shipping company, was upgrade by S&P to BB+. In issuer specific news, Teva was hit with another investigation with risk of fines, this time due suspected anti-competitive behaviour. Recent Lufthansa news gives an indication of how long it will be before the airline business returns to 2019 levels. Recent commentary from the CEO suggests that 2019 levels will not be met until 2025 and even then, will only be 90% of 2019 levels.

Leveraged loans

Leveraged loan prices were not immune to the rate and equity market volatility over the week. The average price of the J.P. Morgan Leveraged Loan Index decreased $0.11 to $98.32 with the average price for BB loans decreasing $0.18 to $99.49, Single B loans decreasing $0.14 to $99.30, and Split B/CCC increasing $0.06 to $90.21. The flow streak continued with an 8th consecutive weekly inflow of $624mn over the week. Year-to-date inflows now total $8.8bn.

Securitised credit

The Agency MBS market posted a small loss last week, down 8bps, which was significant outperformance relative to the Bloomberg Barclays US Aggregate Bond Index, down 80bps. Performance was bifurcated with the lower coupon bonds, which are essentially fully “extended” at this point, outperforming. The “higher” coupons, the 2.5s and 3.0s, are feeling the brunt of the sell-off. Pre-pay speeds continued to accelerate in February, potentially on fears of rising rates and the lows being in the rearview mirror. The Case-Shiller national index finished up 2020 up 10.4%, which is the first time since 2014 that home price appreciation climbed above 10%. Supply remains tight as the inventory of existing homes for sale set a new low in February. In CMBS, spreads widened amidst macro volatility. The commercial sector is the big winner in an accelerating re-opening, however, remains subject to swings in risk-on/risk-off appetite.

Asia fixed income

Las Vegas Sands announced that it will divest its Las Vegas business for $6.25bn and it could potentially focus on more growth projects in Asia, especially in Macau and Singapore. Fitch has also affirmed Sands China’s ratings at BBB- with a negative outlook. S&P affirmed the ratings of Melco Resorts and Studio City but downgraded MCM China and its parent MGM Resorts from BBB- to B+ with a negative outlook. Due to the slow recovery in visitations to Macau, S&P now expects the Macau GGR for 2021 to be 30%-40% below the 2019 levels, compared with its previous estimate of 10-20%.

The latest spectrum auction in India concluded with acquisitions of INR778bn (USD10.4bn) from the mobile telecommunication companies. The spectrum acquired are in the 800MHz, 900MHz, 1800MHz, 2100MHz and the 2300MHz frequency band. The companies, however, did not bid for spectrum in the 700MHz and 2500Mhz frequency band.

Reliance Jio made the highest spectrum acquisition with INR571bn of investment followed by Bharti Airtel (INR187bn, $2.5bn) and Vodafone Idea (INR20bn). Specifically for Bharti, the company increased its spectrum holding in the 1800MHz and 2300Mhz frequency band to support its capacity growth and the migration of 2G subscribers to 4G. Bharti also acquired spectrum in the sub-GHz band (800MHz and 900MHz) to improve its rural and indoor coverage. Altogether, Bharti will make an upfront payment of INR69.8bn and Jio will pay INR199.4bn upfront.

Emerging markets

EMD continued its negative run of the course of last week. Performance has been driven by rising Covid cases combined with the slow pace of vaccine roll-out within EM countries. Hard currency spreads widened 10bps to 332bps, delivering a negative overall return of around -0.8%. Local markets also had a disappointing week largely driven by EM FX. Corporate spreads were more resilient and were flat on the week. Flows for EM bond funds were +$336m, hard currency outflows continued but local currency flows (especially China related) were positive, coming in at $1.4bn.

In central bank news, both Poland and Malaysia kept rates on hold. Ukraine became the third country to hike this year, with a 50bps increase to 6.5%. In Turkey, CPI rose to 15.6% year-on-year driven by rises in health and food groups. This came in spite of the fact that Turkey has some of the tightest monetary policy conditions in the world. In Ecuador, a bill proposed by the sitting president for central bank independence has been rejected; however, the proposal may be pushed through following the upcoming election.

In company specific news, Petrobras announced four of its board members will be leaving; this follows president Bolsonaro replacing the CEO in the preceding week. This has caused concern regarding the future market friendliness of the company going forward.

In country specific news, Brazil announced a $7.8bn Covid aid package for the poor as cases soar across the country. The plan aims to provide four monthly payments of 250 reais to 40 million Brazilians. In Russia, local bonds sold off amid rumours US President Biden may target Russia with more sanctions due to the Navalny issue. Previously imposed sanctions were of a light touch, targeting senior Russian officials. Argentina, one of the worst performers of last week (-2.69%) has still made little progress in IMF restricting talks of a $45bn loan. New bonds have sunk to 30 cents on the dollar despite rising agricultural prices.

Commodities

The commodity index rallied 0.7% last week taking year-to-date returns to 10%.

Despite the improving global economy the OPEC+ meeting on Thursday resulted in no production hikes. Saudi Arabia was expected to bring more production online following a previous 1 million barrel per day cut. The rationale to restrain production is driven by OPEC betting that higher prices won't bring US shale production back online. WTI and Brent rallied 7.7% last week.

In base metals, the biggest loser of the week was nickel, with a 11.6% decline. This was driven by Tsingshan, the world's largest nickel producer announcing it is diversifying away from supplying the stainless industry and going into the battery materials industry. Copper eased by -0.4% following a string of strong performance. This comes as Freeport-McMoRan stated that copper stocks are at their lowest levels since the mid 2000's, even though many large economies are still hampered by Covid. The mining company has recently announced its intentions to expand several of its US copper mines. In precious metals, gold and silver fell by 1.8% and 4.8% respectively on the back of rising treasury yields.

Agricultural commodities declined modestly by -0.3%, soybeans were the strongest performer rallying by 1.8%. The Chinese government announced on Friday it will raise it minimum purchase prices for wheat and rice and expand its corn planting acreage for this year. The state also highlighted the need to stabilise hog production. These measures tie into the "self-sufficiency" element of China's new five-year plan.

Responsible Investments

A new rule for Europe's biggest banks has been proposed to the European Commission by the European Banking Authority that could mean large banks will report on a "Green Asset Ratio". This figure will indicate if the banks are moving towards financing renewable energy projects and steering away from fossil fuels. It will involve disclosing how much of its investments/loans/equity holdings are "green" according to EU definitions.

Planned financing from Toyota Motor Corp. could see a top table position for largest issuance in sustainability bonds globally. The company announced a potential 500bn yen ($4.7bn) and foreign currency sustainability bonds to fund projects involving the use of renewable energy and production of zero emission and assisted mobility vehicles. This only adds to the increasing demand for ESG bonds in Japan that we have been seeing recently. Year-to-date this type of issuance is up 14% in this region.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

8th March 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.	■ 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 ■ 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 £ €	■ 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	■ 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, but could be offset quickly if the USD fails to weaken further.	■ 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. ■ 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 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: subsectors continue to perform divergently, although spreads even in the most affected areas, like office space & convention hotels, have recovered. ■ Our preference remains for non-agency RMBS in this area.	■ 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 ■ u/w Sugar	■ US China trade war

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