INFORMATION FOR INVESTMENT PROFESSIONALS

In Credit

9 AUGUST 2021

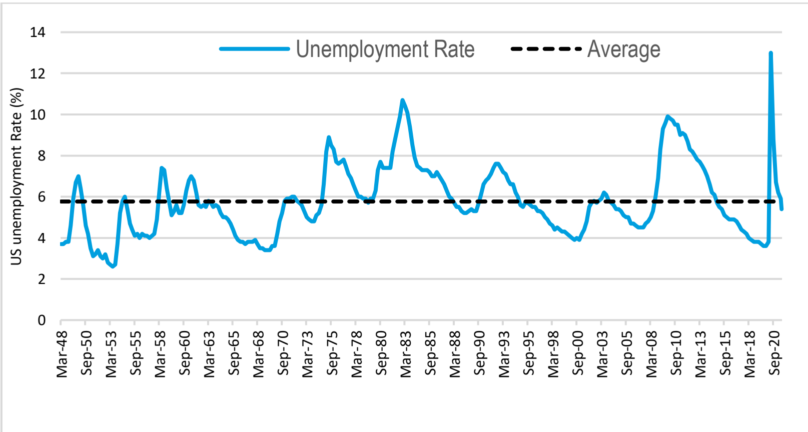
Searching for direction.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.28%	6 bps	-0.3%	-1.7%
German Bund 10 year	-0.47%	-1 bps	0.0%	-0.8%
UK Gilt 10 year	0.58%	1 bps	-0.4%	-3.5%
Japan 10 year	0.02%	-1 bps	0.0%	0.4%
Global Investment Grade	93 bps	0 bps	-0.3%	-0.1%
Euro Investment Grade	85 bps	1 bps	0.0%	0.7%
US Investment Grade	93 bps	2 bps	-0.5%	-0.3%
UK Investment Grade	89 bps	-2 bps	-0.1%	-1.2%
Asia Investment Grade	214 bps	-3 bps	0.1%	-0.1%
Euro High Yield	313 bps	-3 bps	0.3%	3.7%
US High Yield	332 bps	6 bps	-0.2%	3.9%
Asia High Yield	683 bps	-22 bps	1.0%	-2.8%
EM Sovereign	319 bps	-6 bps	0.1%	-0.3%
EM Local	5.0%	5 bps	-0.9%	-4.7%
EM Corporate	312 bps	-5 bps	0.1%	1.6%
Bloomberg Barclays US Munis	0.9%	4 bps	-0.1%	1.8%
Taxable Munis	2.1%	5 bps	-0.4%	2.1%
Bloomberg Barclays US MBS	32 bps	1 bps	-0.3%	-0.4%
Bloomberg Commodity Index	198.58	-1.7%	-1.7%	21.3%
EUR	1.1761	-0.9%	-0.9%	-3.7%
JPY	110.14	-0.5%	-0.5%	-6.3%
GBP	1.3880	-0.2%	-0.2%	1.5%

Source: Bloomberg, Merrill Lynch, as at 6 August 2021.

Chart of the week: US unemployment rate, 1948-2021



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

David Oliphant
Executive Director,
Fixed Income

Contributors

David Oliphant
Macro / Government bonds, Investment Grade Credit

Angelina Chueh
Euro High Yield Credit

Chris Jorel
US High Yield Credit,
US Leveraged Loans

Katherine Nuss
US Investment Grade Credit

Kris Moreton
Structured Credit

Justin Ong
Asian Fixed Income

Doug Rangel
Municipals

Charlotte Edwards
Responsible Investments

Jake Lunness
Commodities
Emerging Markets

Macro / government bonds

Government bonds seem to be struggling for direction amid a summer lull and after a period of strong performance. US 10-year yields have fallen from around 1.75% at the end of March 2021 to around 1.29% at the end of last week. The fall being led largely by lower real yields rather than any material shift in inflation expectations, which remain around 2.36% at the 10-year point.

The most important upcoming market development is likely to be the shape and size of US asset purchase tapering. We expect to receive clarification about the US Federal Reserve's intent at the Jackson Hole symposium, which is held towards the tail end of this month. If the US Fed was looking for reasons for a shift in policy, then the July Non-Farm Payroll report offered such support. 943k jobs were created in the largest month for job adds in a year (there was also a revision higher prior months of 119k). The unemployment rate also fell to 5.4% - see **chart of the week**. Meanwhile, with labour shortages wages rose by 0.4% in the month and 4.7% year over year. As you can see in the chart, the last 18 months has seen the unemployment rate go from the highest since the 1940s to around the average of the period since then.

Elsewhere, in the UK the Bank of England sounded a little more hawkish at its MPC meeting. It noted a concern about the recent rise in inflation with a forecast of 4% for this year before a decline back to target in a couple of years. Bond yields were higher in the week.

Investment grade credit

Somewhat similarly to government bonds, credit markets have also lacked direction recently. Global investment grade (IG) spreads (at 93bps) are wider than the tights (89bps in mid-June) but remain in a very narrow trading range; especially when compared to the volatility of last year.

Taking credit risk has been rewarded this year. High yield markets have outperformed their IG cousins on a risk-adjusted (percent change in spread) basis. Within IG, BBB rated bonds have beaten better quality credit (ie, AAA, AA and A rated) and in high yield the lowest quality CCC rated issuers spreads have tightened more than either BB or B rated debt. In global IG sector performance autos and contingent capital bonds have done especially well with spreads around 20% lower. At the other end of the spectrum, both media and banking have struggled to keep pace with the market with spreads only around 5% tighter this year. The Global IG index spread as a whole is 10bps tighter (and 10%) YTD according to ICE BoAML index data.

The investment grade credit market remains supported by accommodative policy conditions, positive economic performance and improving credit quality. However, spreads are tight. Compared to the last five years they are around 1.0 SDs (standard deviations expensive) and around 0.6 SDs compared with a longer term 20-year history. At this time of year, markets are also helped by the normal light calendar of primary issuance as well as the recent strong earnings season, and ongoing demand for income from investors.

High yield credit

US high yield spreads and yields were wider over the week amid an active primary market and the ongoing threat posed by the delta variant surge. Higher rated issuers continued to outperform while "reopening" related sectors underperformed. The ICE BofA US HY CP Constrained Index returned -0.17% over the week, while spreads and yields were both 6bps wider. The week was also the most active for new issuance since April with $13bn of new deals pricing. According to

Lipper, the asset class experienced a $1.2bn outflow, unwinding the prior week's inflow and leaving YTD outflows at -$15.3bn.

European high yields spreads were better on the week, bucking a widening trend that had been in place since mid-June. It was a generally quiet week overall, with the market led tighter by lower rated CCC credit. European high yield has been outperforming US high yield credit in the last few weeks; the asset class experienced a return to inflows with €340m entering the asset class, largely due to ETFs.

New issuance slowed to a trickle with only two deals amounting to €1.1bn including a new deal from Altice (European cable operator). This takes the YTD issuance to €103.8bn, surpassing total 2020 issuance. Results wise, Rolls Royce bonds rose on an improved outlook as did Lufthansa, the latter on decent earnings figures and the latest UK lifting of entry restrictions. Avis, in the car rental market, also presented strong numbers. Overall, we continue to see generally better than expected Q2 earnings reports with forward guidance being raised, especially in the autos sector. A rare exception was Adient, the world's largest car seat manufacturer. Adient disappointed with numbers below expectations and a slight adjustment down to FY21 guidance, blaming higher commodity prices and time lag to pass through higher prices, as well as chip shortages which are causing operational inefficiencies.

As discussed in IG above, spreads remain well through both shorter term and longer run averages. In terms of yield, the market is within a few basis points of its all-time low.

Leveraged loans

Leveraged loan prices declined $0.08 over the week (measured using the J.P. Morgan Leveraged Loan Index). As with high yield bonds, lower rated issuers and reopening related issuers underperformed. Loan yields and spreads (both to a 3-year takeout) increased 3bps and 2bps, respectively, to 4.84% and +436bps. Inflows for loan funds totalled $130m for the week, well below 2021's average inflow of $700m. For context, the J.P. Morgan Leveraged Loan index is down 0.10% since the delta variant began to weigh on market sentiment in mid-July with gaming / leisure (-0.73%) and transportation (-0.47%) loans lagging.

Structured credit

The US Agency MBS market posted a negative total return for the week of –26 bps, in line with other high quality fixed income assets which struggled on slightly higher rates. Lower coupon mortgages underperformed as prepay speeds came in slower than expected. Technicals and fundamentals favour higher coupons as the market assesses the likelihood of a US Fed taper. The CMBS market mostly traded sideways with mezzanine bonds slightly wider on excess secondary supply. It would appear that investors are taking some profits given the full retracement of spreads to pre-pandemic levels coupled with rising delta variant concerns. In terms of the overall health of the US consumer, the July employment report was solid. Non-farm payrolls beat expectations and the unemployment rate dropped to 5.4%, the lowest it's been since the pandemic began. There remains nearly nine million people without jobs so there is still more work to be done.

Asian credit

On 3 August, the Economic Information Daily (owned by the state-run Xinhua News Agency) carried an article that calls for more regulation of online gaming, which it describes as "spiritual opiums" with detrimental societal impact, especially on school-going students. Tencent responded quickly to affirm its commitment to the online gaming regulations along with additional proactive measures that includes additional limits on playtime; a step-up in identity verification; and assessing whether minors under 12 should be banned from online games.

Adani Ports reported strong Q1 results (ended June 2021), thanks to the consolidation of the Krishnapatnam Port (KPCL) and favourable base effects. The company also raised its FYE March 2022 guidance with throughput of 350-360mmt (+45% y/y) and EBITDA of INR102-107bn (+49% y/y). The guidance includes the 39mmt throughput of the Gangavaram Port and 10mmt of incremental volume in existing ports. Adani Ports has also applied for a general license from OFAC (US Department of Treasury) to operate the controversial Yangon Port in Myanmar.

Bharti Airtel's Q1 performance was satisfactory with its Q1 ARPU of INR146 for its India mobile business (March 2021: INR145). Its 4G data customer rose 2.8% q/q to 184.4m (+33% y/y) which accounted for 60% of its subscriber base). The growth in total subscriber base, however, slowed down to 321.2m (a small 135k net subscriber loss q/q), likely due to delta variant wave that affected net subscriber addition. According to WSJ, Meituan may face a $1bn anti-trust penalty or around 6% of its FY20 annual revenue, which is higher by percentage of revenue compared with the penalty levied on Alibaba ($2.8bn, 4% of FY19 revenue). Anti-trust penalties are capped at 10% of a company's annual sales.

Emerging markets

In Turkey the lira sold off more than 3% following President Erdoğan calling for a base rate cut despite an inflation print of 18.95% in July. The central bank recently revised its year-end inflation forecasts to 14.1%, which is significantly below market expectations of around 16%.

In South Africa, finance minister Mboweni stepped down in the wake of last month's protests. His replacement, Godongwana, is a close political ally of president Ramaphosa. The focus of the new minister will be addressing high youth unemployment and maintaining a sustainable fiscal framework. South Africa have also been considering universal basic income as over half of the population currently lives in poverty.

Commodities

Commodities had a negative week overall with precious metals performing the worst, down -3.4%. Gold and silver fell -3.0% and -4.8% respectively following the strong US payroll data release. Base metals also fell 1.9% driven by Asian covid concerns. Energy also sold off with WTI being the worst hit, with a 7.7% decline. The drop was driven by concerns of the growing delta variant spread in Asia leading to a decline in energy demand. This was exacerbated by the UN's dire warning on climate change in its newly released IPCC report.

Responsible investments

To expand on the aforementioned IPCC report, the Intergovernmental Panel on Climate Change today released a paper warning everyone that global rising temperatures have been caused by human activity. The report highlights that the past five years have been the hottest on record since 1850, and that in every scenario the earth will have warmed by 1.5C by 2040, and this will occur even earlier if carbon emissions are not drastically decreased. The report is released just three months ahead of the COP26 meeting that will take place in Glasgow.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

9th August 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	▪ 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. ▪ Credit fundamentals across sectors are improving. In fact, some areas see such strong demand turnaround that supply constraints are throttling further growth. ▪ Spreads are near all-time tights and leave little room for the growth story to get derailed, but 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.	▪ 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: 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 £ €	▪ Rangebound government bond market likely, with bias to lower yields ▪ 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	▪ 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 ▪ 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 ▪ Still-favourable global liquidity conditions ▪ 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
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, 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. ▪ 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. ▪ Balance sheets weathered 2020 well, and are deleveraging due to responsibly capital management and good sales growth. ▪ 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 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	▪ Although spreads have recently widened a touch, the Fed buying has overwhelmed highly negative fundamentals, evidenced by the near-zero spreads in bonds the Fed buys and poor performance elsewhere. ▪ These unattractive technicals may persist if the Fed continues buying. Fed buying cannot be expected to increase in 2021, ultimately 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	▪ 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: favoured bonds are still 'story' bonds. A return to normal won't look 'normal' for sectors like office space or convention hotels ▪ 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 ▪ o/w Grains ▪ u/w Livestock ▪ u/w Gold ▪ u/w Natural Gas	▪ US China trade war ▪ Renewed Covid lockdowns

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