COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

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Emerging Markets

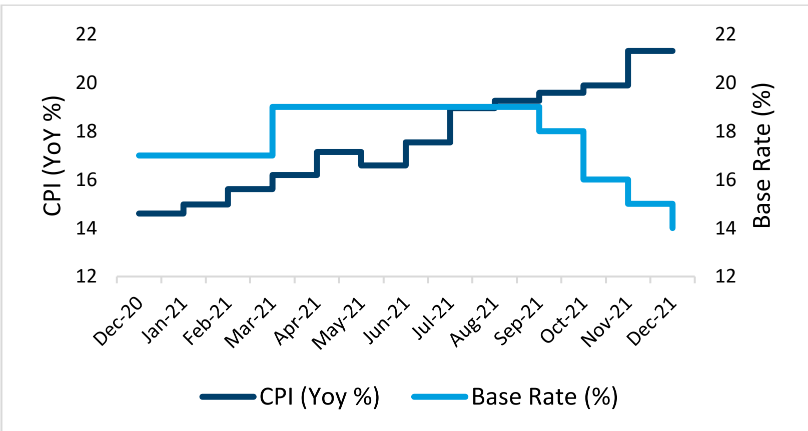
A tough week for Turkey

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	1.37%	-12 bps	-0.1%	-1.9%
German Bund 10 year	-0.40%	-5 bps	-0.1%	-1.1%
UK Gilt 10 year	0.72%	-2 bps	-0.6%	-3.2%
Japan 10 year	0.04%	-2 bps	0.1%	0.1%
Global Investment Grade	102 bps	1 bps	0.2%	-0.6%
Euro Investment Grade	98 bps	-1 bps	0.6%	-0.3%
US Investment Grade	101 bps	1 bps	0.0%	-0.8%
UK Investment Grade	98 bps	-1 bps	0.1%	-1.7%
Asia Investment Grade	200 bps	10 bps	-0.1%	-0.1%
Euro High Yield	353 bps	-1 bps	0.8%	3.3%
US High Yield	336 bps	7 bps	1.1%	4.6%
Asia High Yield	877 bps	55 bps	-0.6%	-13.1%
EM Sovereign	338 bps	9 bps	1.3%	-1.6%
EM Local	5.7%	4 bps	0.7%	-9.5%
EM Corporate	324 bps	9 bps	0.4%	0.9%
Bloomberg Barclays US Munis	1.1%	-1 bps	0.1%	1.5%
Taxable Munis	2.2%	-5 bps	-0.5%	2.4%
Bloomberg Barclays US MBS	37 bps	4 bps	-0.1%	-1.0%
Bloomberg Commodity Index	202.61	-0.5%	0.7%	23.6%
EUR	1.1271	-0.6%	-0.9%	-8.0%
JPY	113.41	-0.3%	-0.5%	-9.1%
GBP	1.3206	-0.2%	-0.4%	-3.1%

Source: Bloomberg, Merrill Lynch, as at 20 December 2021.

Chart of the week: Turkey base rate vs CPI



Source: Bloomberg, Columbia Threadneedle Investments, as at 20 December 2021.

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Macro / government bonds

All three major central banks making decisions last week have demonstrated that they no longer regard the downside risks to economic activity over the coming months as outweighing the need to address inflation pressure.

The Bank of England surprised the market with an 8 to 1 vote to raise the benchmark rate 15bps to 0.25% on Thursday morning. This is the first hike since August 2018, made on the back of an inflation rate print in November of 5.1%, well over the 2% target and raised despite new Covid variant worries. The committee has forecasted that inflation should peak in April at 6%, staying around 5% throughout the winter. Gilts sold off immediately after the announcement, with a steepening bias, and sterling rallied. A further hike (~20bps) is already being priced into the market for February 2022. The Bank has previously signalled that balance sheet reinvestments will cease as the base rate reaches 50bps, which implies that its significant holding of the Gilt 4% 3/2022s will now roll off if it hikes at the next meeting. This assumption added to upwards pressure on yields.

This direction of travel follows the tone of the US Federal Reserve, who confirmed a widely telegraphed acceleration in tapering as well as much as three rate hikes in 2022 at Wednesday's FOMC meeting. A hawkish European Central Bank announced the end of PEPP in March next year with a slowdown in pace of purchasing over Q1 compared to the last quarter. The ECB also announced a step up in the Asset Purchase Programme (APP) to €40m a month in Q2 2022, €30m in Q3 and €20m from October "for as long as necessary to reinforce the accommodative impact of its policy rates". Rate hikes are not expected until 2023.

We do not see the current inflationary pressures leading to sustainable pay rises and expect the combination of negative real wage growth, fiscal headwinds, and tighter monetary policy, at the margin, to weigh on the UK economy going forward.

Investment grade credit

The credit market remained stable through last week's news; most spread levels were within +/- 1bps on the week. The market seems very much in keeping with the themes of last week and preparing itself for the seasonal lull.

The UK public transport company, National Express, announced it would be buying Stagecoach in an all-share deal to become the country's largest road transport provider.

High yield credit & leveraged loans

US high yield bond prices were mixed over the past week as investors assessed this week's policy shifts by central banks. According to Lipper, the asset class reported its third consecutive retail outflow with a $200m withdrawal over the week. Meanwhile, capital market activity was negligible amid a seasonal slowdown. The average price of the J.P. Morgan Leveraged Loan index declined $0.02 over the week and is now $0.36 below November's high as markets absorbed a number of central bank decisions ahead of a seasonally strong stretch. Retail inflows did resume with an $859m contribution following two consecutive mild outflows.

Despite or due to the multitude of central bank news this week, European High Yield (EHY) was fairly subdued as the holiday lull was increasingly apparent. Liquidity was generally challenged over the week with a liquidity premium creeping in to get trades done. While BBs posted a negative return for the week, CCC outperformed but with just marginally positive performance. Outflows continued another week for the asset class with €141m out via ETFs and managed accounts. The primary market is now closed for 2021. While refinancings are expected to be lower in 2022, the wild card will be how much M&A activity transpires next year as that will likely dictate next year's issuance size for EHY.

Already on the M&A front, Brookfield's acquisition of Modulaire, a British services group, was completed on Monday. This mean the likely redemption of the outstanding Modulaire bonds. Also announced last week was purchase of Vine Acquisitions (owners of Punch Tavern) by the private equity group, Fortress. Valuation is thought to be in in the £1bn+ area.

In credit rating news, Talk Talk was downgraded by S&P to B with negative outlook. Weaker than expected operating performance triggered the rating decision.

Structured credit

The US Agency MBS market posted a strong rally on lower interest rates. The sector was up 18 bps alongside other investment grade asset classes. While the housing market remains on healthy footing, for the first time since the April print Case-Shiller did not set a new record for YoY home price appreciation. At 19.5% YoY, the pace of growth slowed a whopping 30bps from the month prior, which is still the third-highest print on record. Existing home sales recorded their worst month of the year relative to 2020 in October, down 8% vs. the year prior. New home sales were down over 20% YoY for the fifth month in a row. Existing and new home inventories were down 0.4% YoY but poised to turn positive in the coming months. Lending standards remain conservative, and defaults subdued.

Emerging markets

In Turkey the central bank cut interest rates a further 100bps to 14%, this takes total rate cuts to 500bps since September **(see chart of the week)**. The Turkish stock market dropped 8% on Friday triggering two circuit breakers. Companies have been pushed to speed up their use of hard currencies (US dollar, euro, sterling) to counter their deteriorating balance sheets.

In Chile leftist Gabriel Boric was elected as president by a 56% majority. His higher majority gives him capacity to push for higher taxes (key for the mining industry), greater equality and more climate friendly businesses. The shift to the left in South America is concerning for markets with upcoming elections in Columbia, Brazil and Costa Rica next year.

Russia hiked 100bps to 8.5% as inflation hit 8.4% in November. Russia have already hiked 425bps this year and have been particularly hard hit by food price inflation. In other central bank news Mexico hiked rates 50bps 5.5% and Chile hiked rates 125bps to 4%.

Commodities

Base metals rallied 1.7% on the back of announced smelter closures in Europe as a result of higher energy prices. Energy did moderate with a 2.8% decline over the course of last week however prices still stand at elevated levels.

To make matters worse EDF will shut down two nuclear reactors this week until the end of January following the discovery of cracks on the pipes of a reactor at the Civaux power plant.

In more positive news Asia's relentless buying of LNG means the region is now well stocked leaving capacity for some shipments to be diverted to Europe.

Responsible investments

European Union leaders failed to reach an agreement on a response to the energy crisis at a summit in Brussels last week. According to Bloomberg, the private talks became heated, and nations were in dispute about the price of carbon permits in the EU Emissions Trading System (ETS). Permits rose to €90.75 per metric ton last week and are around 150% higher this year.

Some mainstream retailers across Europe have stopped purchasing beef produce from Brazil, as it's recently been discovered that cattle production has been linked to the deforestation crisis in the Amazon, Cerrado and Pantanal. Sainsbury's, in the UK, and Carrefour, in Belgium, are part of the six retail groups suspending purchases due to a report released stating the findings.

Summary of fixed income asset allocation view

Fixed Income Asset Allocation Views

20th December 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	▪ 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 and central bank accommodation. 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 fears continue into 2022. 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 continue to be capped by long-run structural downtrend in real yields ▪ Inflation likely to prove largely transitory ▪ Hiking cycles to be shortened by easing inflation and moderating demand ▪ ECB to lean against rising financing rates	▪ Inflationary dynamics become persistent ▪ Labour markets see broad-based wage pressure ▪ Fiscal expansion requires wider term premium ▪ Long run trend in safe asset demand reverses
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 ▪ Tactically reduced EURUSD short given the uncertainty around Omicron and potential impact on Fed tightening cycle.	▪ Re-acceleration of global growth forecasts led by reversal of China credit contraction ▪ US fiscal push fades ▪ Omicron variant requires reimposition of health measures and knocks Fed off course, to the benefit of low yielding majors versus the Dollar.
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	▪ Valuations are getting increasingly more attractive ▪ 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).	▪ Spillover from China's credit woes ▪ 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 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 continue to be a more attractive part of the show better valuations relative to corporates. ▪ 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, although mounting negative headwinds (inflation, supply disruptions) are increasing pressure for higher yields. ▪ 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's taper was well advertised and saw a muted market reaction upon official announcement. ▪ Valuations remain extremely rich, with unattractive carry in many Specifies Pools and CMO deals ▪ 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. ▪ 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 in this area. ▪ Opportunities with repricing risk premiums in new issues ▪ 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.	▪ Attractive shorter duration deals coming into market, provide less carry ▪ 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 Oil	▪ US China trade war ▪ Renewed Covid lockdowns ▪ Global Recession

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