INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

14 MARCH 2022

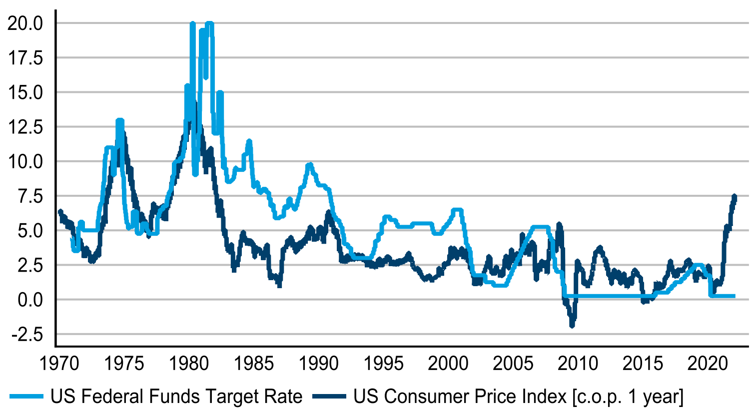
Fed poised for lift-off.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	2.09%	36 bps	-1.3%	-3.9%
German Bund 10 year	0.35%	42 bps	-0.7%	-3.0%
UK Gilt 10 year	1.59%	38 bps	-1.3%	-6.7%
Japan 10 year	0.20%	4 bps	0.0%	-1.3%
Global Investment Grade	151 bps	9 bps	-2.2%	-6.8%
Euro Investment Grade	154 bps	0 bps	-1.1%	-4.9%
US Investment Grade	150 bps	12 bps	-2.7%	-7.8%
UK Investment Grade	129 bps	2 bps	-1.3%	-6.2%
Asia Investment Grade	245 bps	13 bps	-2.1%	-5.2%
Euro High Yield	469 bps	-13 bps	-1.3%	-5.8%
US High Yield	405 bps	15 bps	-1.9%	-5.4%
Asia High Yield	997 bps	107 bps	-7.5%	-15.3%
EM Sovereign	429 bps	-11 bps	-2.2%	-10.3%
EM Local	6.2%	-48 bps	-3.6%	-8.5%
EM Corporate	426 bps	8 bps	-2.3%	-8.6%
Bloomberg Barclays US Munis	2.1%	23 bps	-1.3%	-4.4%
Taxable Munis	3.1%	31 bps	-3.6%	-7.9%
Bloomberg Barclays US MBS	30 bps	2 bps	-1.0%	-3.5%
Bloomberg Commodity Index	265.87	-0.5%	10.3%	27.5%
EUR	1.0974	-0.1%	-2.7%	-4.0%
JPY	117.84	-2.1%	-2.0%	-1.9%
GBP	1.3054	-1.5%	-2.9%	-3.7%

Source: Bloomberg, Merrill Lynch, as at 14 March 2022.

Chart of the week: US CPI vs Fed Policy Rate



Source: Macrobond, Columbia Threadneedle Investments, as at 14 March 2022.

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4529454 Issued March 2022 | Valid to end May 2022

Macro / government bonds

Market volatility remain heightened last week with core government bond yields see-sawing down then up in response to the latest developments in Ukraine. The highest-level meeting held since the start of hostilities between Ukraine and Russia occurred last Thursday. However, the summit, held in Turkey, with the country's foreign ministers yielded little progress. Ukraine had offered to abandon plans to become a member of NATO, but Russia wants more, including total surrender. The conflict continues.

Central banks are caught between 'the rock' of continually rising inflation and 'the hard place' of economic uncertainty arising from the consequences of the war. Against that background, the European Central Bank met last week and, as expected, left interest rates unchanged. However, asset purchases made under the PEPP will end this month while the ECB opened the door to ending purchases made under the APP in Q3, 2022. Interest rates, it noted, will not be altered until after the end of asset purchases. So, this would seem to make late Q3 or Q4 'open season' for a rise in rates, unless inflation falls. Euro government bond yields rose on this announcement, with peripheral spreads widening.

Back to rising inflation. The US consumer price index surged higher by 7.9% over the past 12 months (up from 7.5% last month) to a fresh, 40-year high. Worse still, this data release mostly covered a period before the most recent spike higher in oil prices. The core rate, which excludes volatile food and energy prices, rose by a 'mere' 6.4%. A rate hike this week will follow (the first since 2018) with more to come in the following months – **(see chart of the week).**

Investment grade credit

Credit spreads continue on a widening trend, in place since autumn of last year.

Normally at such times credit market returns are 'bailed out' by falling government bond yields; not this year. The combination of lower government bond prices and wider spreads has meant that total returns this year are the worst since the inception of most indices and include other periods of crisis such as GFC and early 2020.

For context, global IG spreads are now around the long-term average; so cheaper than was the case but not especially cheap. This is even more so the case when we consider that the index average credit quality has worsened, and interest rate risk increased in recent years.

However, in signs of a return to more normal market conditions and behaviour there was a busy schedule of new issuance last week. Indeed, US media giant Discovery marketed the equal fourth biggest corporate bond in history. It priced a multi-tranche deal amounting to $30bn, which attracted an impressive order book of over $100bn.

High yield credit & leveraged loans

US high yield bond valuations widened over the week as the crisis in Ukraine intensified and the ensuing surge in commodity prices weighed on risk assets. The ICE BofA US HY CP Constrained Index returned -1.51% and spreads were 15bps wider over the week. According to Lipper, outflows continued with a $1.6bn withdrawal over the week. This was the ninth consecutive withdrawal with a cumulative outflow of nearly $20bn over the said period. Leveraged loans were not spared from the risk off tone with the average price of the J.P. Morgan Leveraged Loan index declining $1.08

over the week, its largest weekly US dollar price decline since March 2020. The retail fund inflow streak continued, although just barely, with a $15m contribution. YTD inflows total $13.4bn.

It was another week of losses for European High Yield (EHY) but due to the rise in core government bond yields as EHY credit spreads tightened in last week, the first time since early January. Single Bs were the best performers with CCCs the worst. High quality assets such as telecoms outperformed while debt with Russian exposure suffered. There is increasing dispersion among sectors as those with cost pressures (eg, autos, airlines, and chemicals) showed underperformance relative to more defensive sectors such as telecoms and gaming. Outflows continued, this time with €505m out, and largely via managed accounts. This takes outflows YTD to €3.4bn. The primary market remained shut given market volatility, even with the tighter spreads by Friday's close. Days of market rebound/strength still seemed to be seen as selling opportunity for risk reduction with liquidity still generally poor.

In credit rating news, Moody's downgraded Telecom Italia to Ba3. The market is waiting for the issuer to decide on the KKR bid, which continues to be quite a bit higher than the market price (€0.505 vs €0.30). It's full circle for Kraft as S&P upgraded it to BBB-, moving the issuer back to IG. Kraft was one of the first IG corporates to fall to high yield at the start of the Covid pandemic.

There was good news for EHY default rates, which fell from 0.9%, at the end of 2021, to 0.4% by end of February. Recovery rates remains high at 83%. Still, JPMorgan raised its default estimate to 1.5% (from 0.75%) on commodities supply worries. There is concern that current spreads are implying a default rate of 4% (if one assumes that recovery rates fall to 50%).

Though most Q4,2021 financial reporting met or beat expectations, the outlook forward appears less certain, especially for those firms where energy is a high proportion of costs. The Italian paper products manufacturer, Pro-Gest, announced it will shut some paper production centres as these are currently not economical to run due to the excessively high energy prices. Production costs are now higher than the price at which paper can be sold.

Structured credit

The US Agency MBS market suffered a 1.23% decline in total return last week on rising rates and a continued drift in spreads. News in the US paled to rising European geopolitical risk and a more hawkish ECB. Mortgages found a bid on the relative volatility and outperformed high-quality peers. That said, the trend in spreads is wider as we expect to see monthly caps announced this month on agency MBS impacting the supply/demand balance. Non-qualified RMBS has been more challenged YTD. Spreads are at their widest levels in several years, outside the very volatile first few months of the pandemic. Weighing on spreads is largely macro in nature as consumer behaviour remains constructive and delinquencies remain low. That said, robust new issuance has the market 26% larger in the last few months, which has been tougher to absorb. In CMBS, spreads rallied across the stack. An expected slowdown in new issue should provide further support for the sector.

Asian credit

In the Chinese property sector, various companies are working to extend the payment timelines for their near-term debt. Sunac has obtained sufficient bondholder consent to add a put option (exercisable in 2023) to its onshore 4.78% bond, which is puttable on 1 April 2022.

Shimao Group also announced that it has received approval to defer payments on its CNY1bn asset-backed note (due 17 March) with a 30% upfront principal payment. Zhenro Properties disclosed that eligible holders representing around 86%-92% of four offshores notes and 98% of an onshore note have agreed to the proposed debt/exchange offer. The company has also extended the tender offer by another week to 18 March, and it expects to settle the debt exchange on or about 29 March 2022. S&P has downgraded Logan Group to CCC- with a negative outlook (previous: B- Watch Negative) to reflect the risk of non-payment and potential debt restructuring. Logan Group is in the midst of negotiating the repayment terms and maturity extensions for its onshore bond.

Emerging markets

US officials stated that Russia asked China for military support in its invasion of Ukraine. The US is meeting with Chinese officials in Rome today to convince them not to support Russia. Hong Kong's Hang Seng Index saw its biggest decline since 2008 on the fear of potential sanctions hitting Chinese businesses. To make matters worse, Tencent Holdings, one of China's biggest technology firms, is facing a possible record fine for anti-money laundering violations.

A Russian airstrike hit a Ukrainian training centre 10 miles from the Polish border. This is where much of the western aid to Ukraine is coming through, via Poland, including equipment such as critical anti-tank weapons, that have stalled Russia's advance. The attack marks the escalation of the Russian assault deeper into western Ukraine. In response to sweeping sanctions imposed on Russia, the Kremlin has hit back with an export ban on more than 200 products, effecting 48 countries including the EU and US. The ban covers telecoms, medical, vehicle, agricultural, electrical equipment and timber. However, the ban stops short of banning the export of key raw commodities and fertilisers. In China, the PBOC said it will transfer more than 1trn yuan in profits to the government to finance fiscal spending. The profits arose from income accumulated on foreign exchange reserves and will be used on tax rebates for companies and to boost local government spending. In central bank news, Poland hiked rates 75bps to 3.5% and revised its inflation projection to 10.8% in 2022. Elsewhere, Peru hiked rates 50bps to 4%.

Commodities

Nickel rallied 65.1% last week following a short squeeze on Chinese tycoon, Xiang Guangda, owner of the world's largest Nickel producer, Tsingshan Holdings Group. LME trading for nickel was closed on Tuesday and remains shut for now. Xiang amassed a huge, short position via his company on expectations that prices would moderate following the post covid rally, this was supported by his company's plans of ramping up nickel production by 40% in 2022. Following Nickel prices surging because of Russia's invasion of Ukraine, Xiang was forced to close out some of his positions after being unable to meet margin calls. Xiang still has a substantial short position and is in talks with numerous banks to secure a credit facility.

Brent oil prices moderated 3.9% last week closing north of $110 a barrel. Prices surged to $130+ following the news of a Russian oil and gas ban from the United States and given the UK announcement that it will phase out Russian oil imports by the end of the year. The impact on the US is moderate given it only imports a small volume of barrels from Russia; however, the move signals the potential for a wider Iranian style energy ban.

Wheat prices fell by 8.5% coming down from multi-year highs. The Ukrainian government suspended the export of wheat and other staples last week; there are fears that Ukraine's capacity to export is likely to be impeded going forward due to damage to key ports.

Responsible investments

The United Nations Environment Assembly met last week in Nairobi for the fifth biennial session. It was decided that an inter-governmental committee is to be formed to negotiate a treaty that will be legally binding, to combat the proliferation of plastics. According to UN experts, nearly 11 million metric tons of plastic waste ends up in bodies of water every year and will triple by 2040 if no action is taken. The treaty is proposed to be in place by the end of 2024, which in standard global treaty timelines is extremely fast acting.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

14th March 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	▪ Credit spreads have widened during recent volatility, which has been paired with neutral to worsening technicals and stable fundamentals in most sectors. This has created more pockets of opportunity, along with the deleveraging & upgrade stories. ▪ 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 due to fears surrounding central bank hiking, inflation, supply disruptions, and the escalating Russia-Ukraine situation	▪ 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: Covid variants worsen. 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 invasion of Ukraine will hit global growth, hinder risk markets and lend a bid to the Dollar ▪ The associated impact of higher inflation on central banks is uncertain, but is more likely to see a dovish repricing of the ECB than the Fed, we turn neutral on the Euro	▪ The ECB becomes concerned around potential second round effects and presses on with policy normalisation
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. ▪ Weakening technicals with large fund outflows and slower supply
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ US spreads are 25bps off tights of last year and near 5y average. EMEA spreads have also widened but remain rich to long-run averages. ▪ IG has been historically resilient in the face of inflation, which has been broadly supported by earnings ▪ 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 have widened relative to 2021, creating buying opportunities for high conviction and rising star trades. This volatility is expected to continue ▪ Bank loans are attractive as they have shown better performance relative to corporates, with 2022 expectations of strong new issuance and strong demand from CLO formation and retail fund inflows. ▪ 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, a theme seen across HY/loans sectors.	▪ 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 continue 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	▪ The risk/reward mix in MBS Basis remains asymmetric. ▪ Specified Pools and CMOs have cheapened into market sell-off with fair fundamentals: buy opportunities. ▪ Valuations have widened since November, recently stabilizing in wider range like 2018-2019 levels. Elevated 2022 supply projections remain a headwind.	▪ Housing activity slows considerably, and rising rates move prepays 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 ▪ Have seen modest widening across the set, keeping an ▪ eye on sentinel slight upticks in defaults ▪ RMBS: Housing continues to outperform in the recovery with improving supply and strong balance sheets & demographics. Affordability waning but near average. Has attractive spread for the risk, with good carry and relval opportunities. ▪ CMBS: Most segments maintain strong fundamentals with retail & hospitality improving. Spreads slightly wider YTD. ▪ CLOs: Spreads mostly wider, with attractive fundamentals and technicals, less new issue has helped new issue outperform while seeing some weakness in secondary	▪ 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	▪ Global Recession

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