COLUMBIA THREADNEEDLE INVESTMENTS

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# In Credit

10 MAY 2021

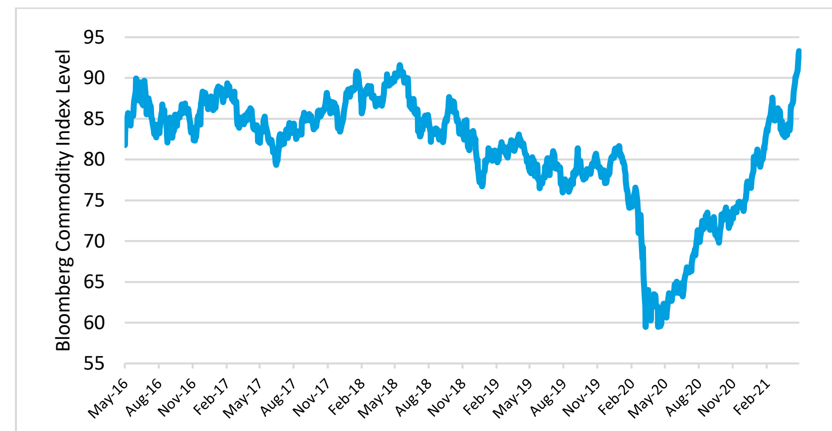
## 'Brass in pocket'.

### Markets at a glance

| | Price / Yield / Spread | Change 1 week | Index MTD return | Index YTD return |
|---|---|---|---|---|
| US Treasury 10 year | 1.57% | -6 bps | 0.3% | -3.5% |
| German Bund 10 year | -0.21% | -1 bps | 0.1% | -3.0% |
| UK Gilt 10 year | 0.79% | -5 bps | 0.6% | -6.4% |
| Japan 10 year | 0.09% | -1 bps | 0.1% | -0.2% |
| Global Investment Grade | 94 bps | -1 bps | 0.4% | -2.2% |
| Euro Investment Grade | 85 bps | 0 bps | 0.1% | -0.6% |
| US Investment Grade | 93 bps | -1 bps | 0.5% | -2.9% |
| UK Investment Grade | 93 bps | 1 bps | 0.4% | -3.1% |
| Asia Investment Grade | 207 bps | 1 bps | 0.4% | -1.3% |
| Euro High Yield | 314 bps | 1 bps | 0.0% | 2.2% |
| US High Yield | 327 bps | -1 bps | 0.3% | 2.3% |
| Asia High Yield | 546 bps | -1 bps | 0.4% | 1.6% |
| EM Sovereign | 310 bps | -3 bps | 0.7% | -2.2% |
| EM Local | 4.9% | -4 bps | 1.7% | -3.0% |
| EM Corporate | 297 bps | 2 bps | 0.4% | 0.2% |
| Bloomberg Barclays US Munis | 1.0% | -2 bps | 0.2% | 0.7% |
| Taxable Munis | 2.3% | -4 bps | 0.4% | -2.1% |
| Bloomberg Barclays US MBS | 10 bps | 3 bps | 0.0% | -0.6% |
| Bloomberg Commodity Index | 200.44 | 3.7% | 3.7% | 20.1% |
| EUR | 1.2172 | 1.2% | 1.2% | -0.4% |
| JPY | 108.71 | 0.7% | 0.7% | -4.9% |
| GBP | 1.4132 | 1.2% | 1.2% | 2.3% |

Source: Bloomberg, Merrill Lynch, as at 7 May 2021.

### Chart of the week: Commodity prices, 2016-2021




Source: ICE bofAML, Bloomberg, Columbia Threadneedle Investments, as at 7 May 2021.

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## Macro / government bonds

After a weak start to the year, government bond yields have not moved much in the last few weeks. The upward trend of rising inflation expectations continues and is now at 2.5% at the 10-year point of the curve and 2.8% for two years.

The US non-farm payroll / employment sector report released last Friday revealed that there were only 266k new jobs created (1m expected) and that the unemployment rate had risen to 6.1% (5.8% expected). Wages grew by only 1.6% y/y; growth here was constrained somewhat by the return of low-paid services sector staff. Buoyant US business confidence fell a little last month but remains high. The ISM PMIs were both strong, but less strong than expected, with the service sector ISM coming in at 62.7, while the manufacturing counterpart was at 60.7.

In the UK, the Bank of England updated its 2021 economic growth forecast. The BoE now expects to see the economy expand by 7.25%, significantly higher than envisioned in its last forecast of 5% in February. If correct, this will take the UK GDP level back to where it was in 2019 by the end of this year. For 2022, growth is expected to be lower to just under 6% (from 7.25% in February). The BoE also announced it would slow the pace of weekly bond purchases, which places the central bank on a 'glidepath' to use its purchase envelope by year-end.

## Investment grade credit

Similar to government bonds, investment grade credit spreads have been locked in a very tight range for most of the last few months. Last week offered no change in those conditions. The Global IG spread remains around 94bps.

We are in the middle of issuer earnings season, which has been broadly supportive for the market and from both banks and industrials. Likewise, improving sentiment about increasing economic growth (eg, BOE last week - noted above) is also supportive for spreads. Primary market activity has been relatively light given we are in results season, so there is no 'supply indigestion' issue.

This 'good news' seems largely reflected in valuations or spreads which are some distance below both short (five-year) and long-term (20-year) averages with both US dollar and euro IG spreads around 9% tighter this year thus far. Cash bonds have outperformed credit derivatives markets in the last few months, narrowing the 'basis' between these markets.

## High yield credit

US high yield spreads were largely unchanged over the week as the new issue market moderated while outflows picked up. The ICE BofA US HY CP Constrained Index returned 0.27% and spreads were unchanged. The index yield-to-worst ended the week 9bps lower at 3.99%. According to Lipper, the asset class reported a $1.4bn outflow, the third outflow over the last four weeks.

It was a sideways week for European high yield as spreads were basically unchanged and CCC credits outperformed. This was partly a function of the slew of new issuance that came to the market mixed with an avalanche of Q1 earnings reports. The primary market was heavy with €3bn issuance. It was also rather mixed with a CCC offering by TUI Cruise (German cruise line operator) being 8x oversubscribed and pricing at the tight end of 6.5% while other higher rated new issues quickly traded below par after launch. Earnings news continued to show good results for industrials but

also some softness in services. The asset class saw positive but small inflows, all into managed funds as ETFs were flat on the week.

In the auto sector, the focus is still on deleveraging but, even as issuers acknowledge supply chain shortages, they are not lowering their guidance for 2021. Instead issuers in the auto space are reaffirming (ex. Gestamp, Adient) or raising (ex. Tenneco) guidance.

In issuer specific news, British Airways reported that Q1,21 was 20% of Q1,19 volume; it expects this to be 25% in Q2,21. The return to normal for airlines continues to be a slow process.

## Leveraged loans

The average price on the J.P. Morgan Leveraged Loan index decreased $0.04 to $98.25 over the week with the average price for BB loans decreasing $0.09 to $99.24, Single B decreasing $0.07 to $99.05, and Split B/CCC increasing $0.13 to $90.77.

## US structured credit

Agency MBS was flat on the week as the curve bull flattened. Prepays slowed in April by approximately 19% primarily in lower coupon mortgages as would be expected; slower prepays in aggregate is supportive of better carry. The US Fed continues to purchase Agency MBS at $40bn a month with the eventual taper on investor minds. Recent comments from Boston Fed President Rosengren noted consideration of the speed at which they taper US treasuries vs MBS and that his own view is that the MBS market "probably doesn't need as much support now" (more to come on that as the year unfolds). CMBS spreads were largely unchanged on the week despite a disappointing April jobs report with most conduit bonds tighter by a couple of basis points.

## Asian credit

Adani Ports & Special Economic Zone (APSEZ) reported positive Q4,20 results, with consolidated revenue growth of 23.5% and EBITDA increase of 39% y/y. Management provided a strong FYE guidance that reflect the contributions from recent acquisitions such as the KPCL (Krishnaptnam Port Company Limited), Gangavaram and Dighi. APSEZ plans to abandon its investments in Ahlon International Port Terminal (2) in Myanmar if the latter is classified as a sanctioned country under OFAC. Management does not expect the write-down, if APSEZ were to exit Myanmar, to be material given that it would be equivalent to around 1.3% of APSEZ's total assets.

International Container Terminal Services (ICTSI) also reported a strong Q1,21 with revenue growth of 16% y/y, throughput growth of 8% y/y and yield per-TEU of USD161 (+7% y/y), thanks to favourable container mix, tariff growth and higher ancillary revenues. ICTSI saw positive y/y growth across Asia (44% of volume), Americas (32%) and EMEA (24%). Including the concession rights payable, lease liabilities and perpetuals, the LTM Q1,21 net debt/EBITDA improved to 4.2x (Dec 2020:4.8x). Q1 FCF was positive at $120m (Q1,20: $50m). For Q2,21, management stated that the throughput at the Manila terminal is approaching pre-Covid levels.

SJM Holdings' Q1,21 net revenue declined to HK$2.48bn (-28.8% y/y) and adjusted EBITDA was negative by $319m (prior year loss: $200m). The decrease in VIP gross gaming revenue was 59.4% y/y, much larger than the decline in mass market gross gaming revenue (-21.3% y/y). At end-March 2021, the liquidity position remained strong at HK$2.48bn (Dec 2020: HK$6.1bn) with HK$10bn of undrawn revolving credit facility (Dec 2020: $6.5bn), compared with total debt of

HK$16.6bn. During Q1, the company issued $1bn (HK$7.7bn) of notes, paid down HK$9.9bn of debt and spent HK$700m on Grand Lisboa Palace. More recently in early May, SJM Holdings issued around $200m of five-year senior unsecured bonds (comprising HK$1.25bn and MOP300m). The company maintains its expectation of opening the Grand Lisboa Palace in H1,21.

## Emerging markets

Emerging market bonds experienced inflows of $499m last week with $300m into hard currency funds and the remainder into local debt.

In central bank news Brazil hiked rates 75bps to 3.5%, while Turkey held rates at 19%, as expected, citing that current rates would be maintained until the April Inflation Report's forecast path was achieved.

In Peru, stocks and bonds rallied sharply as the leftist candidate Castillo's lead narrowed, ahead of the upcoming presidential election. Markets are concerned with Castillo's policies, which include plans for state control over 'strategic industries' and higher taxation to redistribute wealth. Elsewhere in South America, El-Salvador's president removed both the attorney general and the top five judges to consolidate power. The move has been criticised with the country now less likely to receive IMF support as a result.

In Colombia protests began last week in response to proposed sales tax hikes, which have now been cancelled. There have been an estimated 26-36 deaths so far and human rights groups has criticised "alarming" police violence reports.

## Commodities

The Commodity index had a stellar week with all sub-groups advancing. Year-to-date returns are 20.1% and the index stands at the highest level since 2011 (**see Chart of the Week**).

Industrial metals rallied 4.9% with copper (+6.3%) and aluminium (+5.9%) leading the charge. Both have benefitted from supply concerns from China; smelters of both metals have faced mounting pressure to curb pollution and enhance energy efficiency. Copper reached all-time highs driven both by the manufacturing recovery across major economies and investors piling into copper. Investors are betting on enhanced demand given that the metal is key to electrification, and thus the global effort to reduce carbon emissions. Furthermore, a proposed copper sales tax by the world's largest copper producer Chile rounds off a perfect storm for a copper rally. Elsewhere agriculture prices rallied 5% with all constituents rallying between 3-5% excluding corn, which rose 8.8%. The corn rally has largely been driven by dry conditions in South America and tight supply across the market.

Finally, in energy markets, WTI and heating oil rallied 2.2% and 4.5%, respectively, following a Russian cyberattack on the 'colonial pipeline'. This is a key US pipeline that transports 2.5 million barrels a day to the New York Harbour.

## Responsible investments

Last week, Angela Merkel announced that Germany are now targeting to be net-zero by 2045. This is five years sooner than the original target to eliminate carbon emissions. It was only a few weeks ago that we heard from US President, Joe Biden, that the US would also be making an improvement on a climate goal and now aim to double its emissions cut by 2030 to 52% of 2005 levels.

In the UK, IKEA is now offering a ‘buy back’ refund programme whereby customers can bring back their used IKEA furniture for a part refund of 50%, 40% or 30% of the original price (depending on the condition), where that money can only be spent in-store. IKEA will then aim to resell those products to customers at a reduced price and give a second chance of life to popular items instead of sending them off to be destroyed. If the firm is unable to sell the items, it will dispose of them responsibly and recycle where possible. Currently, this is only being offered in UK stores.

Green bond issuance for April was slow; however, in the first four months of this year we’ve seen issuance total $153.9bn, up from $58.2bn in the same period last year. We are still very much on track to beat issuance year-on-year in all responsible investment areas of the market.

# Summary of fixed income asset allocation views

## Fixed Income Asset Allocation Views

10th May 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 data is shaping up to be noisy once again, but in a much different way than 2020. This time, growth is going to be robust, especially in the US. In addition, issuers on the whole are coming into this environment with better liquidity than before the pandemic.<br>■ Valuations in most areas of credit provide much less cushion for volatility. But compared to similar spread levels in the decelerating global economy pre-COVID, we still prefer to carry more credit risk in today's accelerating economy.<br>■ Question marks on the sustainability of super easy financial conditions, inflation, & central bank reaction functions do increase uncertainty. | ■ Rapidly rising Treasury yields tighten financial conditions or make all in yields of credit less attractive.<br>■ A recovering economy propels spreads to all-time tights, especially if vaccinations accelerate quickly<br>■ Geopolitical tensions rise above a simmer, particularly in the US and Russia or China |
| **Duration (10-year)**<br>('P' = Periphery) | P (+1)<br>¥ (0) $ (+1)<br>Short -2 -1 0 +1 +2 Long<br>£ (+1)<br>€ (+1) | ■ Valuations suggest lower yields likely<br>■ Pandemic scarring keeps reflation credibility low<br>■ Fed QE and high personal savings underpin demand for treasuries<br>■ ECB likely to lean against rising financing rates<br>■ Duration remains best hedge for further risk asset correction | ■ Permanent fiscal policy shift rebuilds reflationary credibility and raises r*<br>■ Fiscal largesse steepens curves on issuance expectations<br>■ Consumption rebound stimulates long-term inflation expectations<br>■ Risk hedge properties deteriorate |
| **Currency**<br>('E' = European Economic Area) | £ (0)<br>¥ (-1) EM (0)<br>Short -2 -1 0 +1 +2 Long<br>E (-2) A$ (0) $ (+2) | ■ US growth outperformance on back of fiscal stimulus boosts USD<br>■ ECB increasingly sensitive to Euro appreciation | ■ Vaccine rollout in Europe improves and narrows growth gap<br>■ US fiscal push fades |
| **Emerging Markets Local (rates (R) and currency (C) )** | R (+1)<br>Under-weight -2 -1 0 +1 +2 Over-weight<br>C (0) | ■ Favourable advanced economy policy settings support EM assets in near term<br>■ EM real interest rates relatively attractive, curves steep | ■ Sharp escalation in global risk aversion, leading to higher EM inflation via fx<br>■ EM funding crises drive curves higher and steeper |
| **Emerging Markets Sovereign Credit (USD denominated)** | Under-weight -2 -1 0 +1 +2 Over-weight | ■ The long leash markets gave EMs in 2020 is not extending into 2021. Questions about fiscal stability are rising again (see Brazil).<br>■ Index composition changes over the last 5 years have added a lot of duration to the sector, leaving it vulnerable.<br>■ 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<br>■ Growth scars from COVID persist and hurt commodity prices & ability to grow out of deficits.<br>■ Governments show little willingness to address deficits post-COVID. |
| **Investment Grade Credit** | Under-weight -2 -1 0 +1 +2 Over-weight | ■ Index spreads are back to pre-COVID levels, but the duration of US indices have also lengthened by ~10%.<br>■ Issuer balance sheets still look remarkably strong, and cash reserves remain very high. Our base case is that a fair amount of deleveraging can occur with this cash, but as the economic recovery accelerates and COVID moves to the rear-view mirror, the spectre of M&A and shareholder return still looms.<br>■ 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.<br>■ 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 spreads are still wider than pre-COVID.<br>■ Access to capital remains easy even through more volatile markets of late, and a return to normalcy disproportionately benefits low-quality credits.<br>■ 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, 2020's downgrade cycle turns quickly into an upgrade cycle.<br>■ 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.<br>■ Fed buying cannot be expected to increase in 2021, exposing negative fundamentals and valuations<br>■ 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.<br>■ 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.<br>■ 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.<br>■ CMBS: favoured bonds are still 'story' bonds. A return to normal won't look 'normal' for sectors like office space or convention hotels<br>■ Spread tightening looks somewhat excessive along the margins of credit quality. | ■ Changes in consumer behaviour in travel and retail last post-pandemic.<br>■ Work From Home continues full-steam-ahead post-pandemic (positive for RMBS, negative for CMBS).<br>■ 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 vs Aluminium<br>■ o/w Lead vs Zinc<br>■ o/w Soybeans<br>■ u/w Livestock<br>■ u/w Gold | ■ US China trade war |

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