COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

8 NOVEMBER 2021

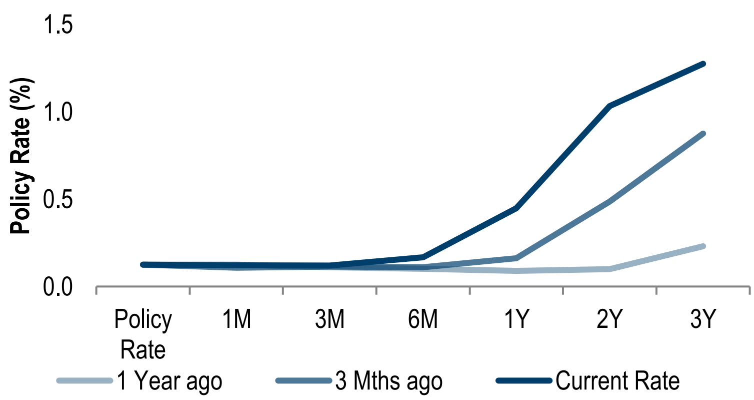
Communication breakdown.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	1.48%	-7 bps	0.7%	-2.0%
German Bund 10 year	-0.26%	-15 bps	1.2%	-1.7%
UK Gilt 10 year	0.87%	-17 bps	1.8%	-3.8%
Japan 10 year	0.06%	-4 bps	0.2%	0.0%
Global Investment Grade	93 bps	2 bps	0.8%	-0.2%
Euro Investment Grade	90 bps	3 bps	0.9%	-0.1%
US Investment Grade	90 bps	1 bps	0.8%	0.0%
UK Investment Grade	92 bps	2 bps	1.4%	-1.7%
Asia Investment Grade	198 bps	10 bps	0.0%	-0.5%
Euro High Yield	341 bps	20 bps	0.4%	3.5%
US High Yield	312 bps	4 bps	0.6%	5.1%
Asia High Yield	900 bps	82 bps	-2.9%	-14.7%
EM Sovereign	329 bps	2 bps	0.6%	-0.9%
EM Local	5.6%	-2 bps	0.4%	-7.3%
EM Corporate	311 bps	11 bps	0.1%	1.2%
Bloomberg Barclays US Munis	1.1%	-6 bps	0.5%	1.0%
Taxable Munis	2.2%	-9 bps	1.0%	2.6%
Bloomberg Barclays US MBS	26 bps	2 bps	0.4%	-0.5%
Bloomberg Commodity Index	219.47	-0.6%	-0.6%	31.7%
EUR	1.1570	0.1%	0.1%	-5.3%
JPY	113.39	0.5%	0.5%	-8.9%
GBP	1.3542	-1.3%	-1.3%	-1.3%

Source: Bloomberg, Merrill Lynch, as at 8 November 2021.

Chart of the week 1: US Interest rate expectations & history



Source: Bloomberg, Columbia Threadneedle Investments, as at 8 November 2021.

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Macro / government bonds

Bond markets, which have been under considerable pressure recently, saw a very sharp turnaround last week as the US Federal Reserve did no more than expected in the US, while the Bank of England kept rates unchanged, and the European Central Bank was at pains to make clear that rates are not going to change anytime soon. These decisions/comments taken collectively took the bond market by surprise and suggest some degree of communication breakdown between policy maker's intentions and investors' expectations.

As mentioned, the US Federal Reserve took its first steps towards a normalisation of policy conditions last week. A widely anticipated tapering in the purchases of assets was announced, where the central bank will now reduce its purchases of government bonds by $10bn and Mortgage-Backed Securities by $5bn from this month. The Fed will adjust this pace if the economic background changes. The reasons for doing this reflect a recovery in the economy and inflation that is taking longer to shake off than expected. There was little reaction to the announcement and bonds. Present market expectations and history are recorded in **chart of the week 1.**

In terms of the recovery in the economy, the ISM Services PMI reached an all-time high last month, exceeding expectations. The week also ended with another strong economic data point, the monthly employment report. 531k jobs were created, which is well above the expectation on 450k with a hefty positive net revision of 235k to prior months numbers. The unemployment rate fell to 4.6% from 4.8%, below the consensus of 4.7%. Average hourly earnings increased by 0.4%, in line with expectations.

All change in the US, but do not expect the same in Europe. ECB President Christine Lagarde reiterated that an increase in rates is very unlikely in the coming year. The ECB continues to believe that the (one-off) reopening of economies, a significant surge in energy prices and supply chain issues (which are expected to fade over the coming year) have forced prices higher are transitory factors and that 'order' will be restored in due course. This rhetoric soothed fears of a tightening in monetary policy in the eurozone. In data releases, the unemployment rate fell in September to 7.4%, a tenth lower than last month. This rate is still slightly above the pre pandemic levels (7.1%) but a lot lower than the 8.6% rate recorded in Q3,2020.

From dovish rhetoric to inaction: the Bank of England left interest rates unchanged in the UK last week. It faces the same issues as elsewhere, with inflation higher than target. The base rate has been at 0.1% since pandemic driven cuts from 0.75% in March of last year. Market expectations were evenly split on whether the Bank would raise rates. The Bank expects inflation will reach 5% next spring. The decision sent UK gilts sharply higher in price. The benchmark 10-year UK gilt, which was yielding around 1.2% a few days ago fell below 0.9% by the end of the week.

Investment grade credit

So how did all the central bank activity and inactivity leave credit markets?

There was a very small widening in spreads though not a large enough move to take spreads out of the narrow range they have been in for a number of months.

As long as policy conditions remains on the right side of accommodative then this persists as a positive lever to support the market. While the US Fed has started its journey to normalisation it would be hard to argue than present and expected monetary policy conditions are anything other than supportive for spreads. This at a time when the European Central Bank's buying programme has more than offset net new supply.

Last week, primary market activity picked up somewhat as we come toward the end of earnings season.

High Yield credit

US high yield spreads were stable over the week as a solid corporate earnings season continued, the FOMC meeting contained few surprises, and as dovish pushback from the RBA, BoE and ECB served as a tailwind for front-end US rates. The ICE BofA US HY CP Constrained Index returned 0.59% and spreads were 4bps wider. According to Lipper, the asset class reported a $1.3bn outflow.

European high yield had a good start for November with positive returns for the first week even as spreads widened 7bps with CCCs outperforming and single Bs the worst performers. The primary market was busy, its heaviest since February, with issuance of 8 deals totalling €6bn. It was a good mixture of BB to CCC rated bonds and with many issued as sustainability-linked bonds. Overall, the market tone was supportive with plenty of buying interest as pricing wasn't too aggressive. Secondary market trading also saw better traction. On the supply side, flows were basically flat as funds into managed accounts largely offset funds exiting via ETFs.
The earnings reporting season continues with results generally strong, and good pass through of raw material cost / logistic cost increases. Most fiscal year outlooks have either been affirmed or raised with leverage targets being met, while a number of companies are starting to prioritise shareholder returns via buybacks or special dividends.

In upgrade potential news, Kraft was put on positive watch by S&P (BB+) with a potential rating upgrade in the next 12 months if management can pass on price increases to support margins given cost inflation, uses disposals for debt reduction and manages its balance sheet less aggressively to support an IG rating. If this happens, it will be another relatively quick turnaround from a Fallen Angel to a Rising Star given Kraft was one of the first rating downgrade victims of the Covid pandemic.

Leveraged loans

Leveraged loans provided modest gains over the week aided by a firm technical and a rise in idiosyncratic trading in response to earnings. Retail loan funds posted a $585m weekly inflow, marking the 42nd inflow in 43 weeks.

Structured credit

Last week, the US Agency MBS market generated 40bps of total return for a 4bps excess return MTD. The US Fed announced the expected taper on Wednesday at a pace of $5bn Agency MBS and $10bn US treasuries per month. OAS on mortgages widened marginally; October prepays came in slower vs September with a 6% decrease in 30-year conventionals. Gross issuance was mostly unchanged at $273bn in October. Mortgages have historically tightened into year-end and demand, in general, continues to be strong despite the taper news.

In credit, $6bn of new issue was priced last week, which represents a 30% decline in volumes. Spreads traded sideways.

CMBS spreads rallied on the week. Secondary trading volumes have been consistently elevated giving way to ample liquidity. Money manager demand has picked up as well which has supported the belly of the capital stack. In terms of pricing, the most recent new issue deal priced the BBB/BBB- tranches at 225/330bps which was 30 and 60bps wide of the YTD tights respectively.

Asian Credit

Bharti posted a strong set of Q2 results with EBITDA of INR140.2bn (+18.3% y/y, +6.3% q/q), thanks to the positive performance in India and Africa. The ARPU in India improved to INR153 (Q1: INR146) and mobile services customers grew to 323.5 million (+10.1% y/y).

Logan Group has launched a repurchase offer for its $244m bond that matures in January 2022, which serves to shore up confidence in its ability to address near-term maturities. On another hand, Yango Group which is facing liquidity stress has announced a consent solicitation to extend the maturity of three US dollar notes to September 2022.

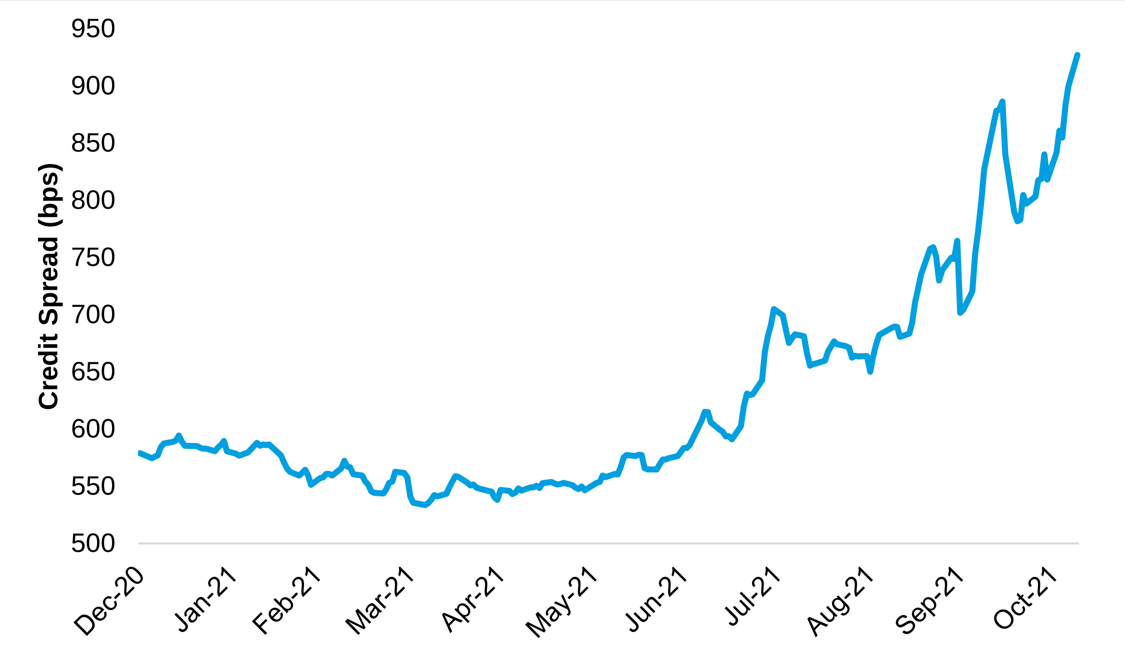
Emerging markets

In Chinese real estate, property company Kaisa Group defaulted on a payment of a wealth management product, due to tightening credit conditions. Asian high yield credit spreads widened 82bps on the week **(see chart of the week 2),** JP Morgan expects a 13% default rate in Chinese high yield names in 2021. The default comes as Evergrande made a second '11th hour' coupon payment on the final day of its 30-day grace period.

In Peru, protestors in the rural community of Aquia are demanding higher tax contributions from the copper mines in the region. The protests are as a result of President Castillo's previous pledge for rural Community development, the support of these communities was key to Castillo's election campaign.

In Eastern Europe, Poland and the Czech Republic delivered bumper rate hikes in response to persistently higher energy prices. Poland hiked rates by 75bps to 1.25% and the Czech Republic delivered a 125bps rise to 2.75%.

Chart of the week 2: Asian High Yield Credit Spreads



Source: Bloomberg, JP Morgan and Columbia Threadneedle Investments, as at 8 November 2021. The chart refers to the J.P. Morgan JACI Non-Investment Grade Corporates Blended Spread Index (JACINCBS Index).

Commodities

Aluminium was the biggest mover, down 6.1% on the week, the decline being driven by rising Chinese coal stockpiles. Coal imports rose 96.2% year on year whilst domestic production was boosted from the removal of mining quotas. As a result, only a few provinces in China are still grappling with power shortages.

WTI fell by 2% on the week, OPEC+ stuck to its moderate production hikes of 400k barrels a day, despite pressure from Joe Biden to raise production more aggressively. The fall was driven by speculation that the US may use its strategic petroleum reserve to boost supply.

Responsible investments

In a very busy week for climate talks at COP26, it's been exciting to see what countries are pledging to do to ensure the planet doesn't warm up. Early in the week, we heard from the Prime Minister of India who, unlike most other high carbon emitters, pledged to be net zero by 2070, 20 years later than the majority of other nations. This did include certain measures that will be met along the way, such as 50% renewable energy by 2030, which for one of the world's top carbon emitters will bear a noticeable impact. A global deal to stop and reverse deforestation by 2030 was made mid-week, with over 100 leaders representing over 85% of the world's forests signing the deal. Countries including Canada, Brazil, Colombia and Indonesia were among those who signed.

You can find a thought piece from our Responsible Investments team on the run up to COP26 here: https://www.columbiathreadneedle.co.uk/en/intm/insights/cop26-an-opportunity-to-heighten-climate-ambitions/

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

8th November 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. ■ 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 central bank accommodation. The pullback in liquidity won't be aggressive, but it leaves opportunity for market volatility. ■ Uncertainty is rising as Delta threatens the recovery, 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 Delta variant cases worsen and restrictions return, threatening returns to schools, offices and travel 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 £ €	■ Yields have broken out of their earlier tight ranges but likely to remain capped by structural downtrend in real yields and growth ■ 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	■ Inflation becomes more persistently entrenched, warranting much higher rate structure ■ 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$ $	■ 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	■ Re-acceleration of global growth forecasts led by reversal of China credit contraction ■ 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 ■ 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	■ 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).	■ 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 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	■ The Fed has been the 1000lb gorilla in this market since COVID hit, and it is progressively getting closer to tapering. The Fed will taper MBS alongside USTs, but tapering will still be a headwind to the market. Banks, the other major buyers, have slowed their purchases as well. ■ 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. The Fed maintains or increases MBS purchases next year. ■ 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: 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.	■ 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 Soybeans ■ o/w Oil	■ US China trade war ■ Renewed Covid lockdowns ■ Global Recession

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