COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

29 NOVEMBER 2021

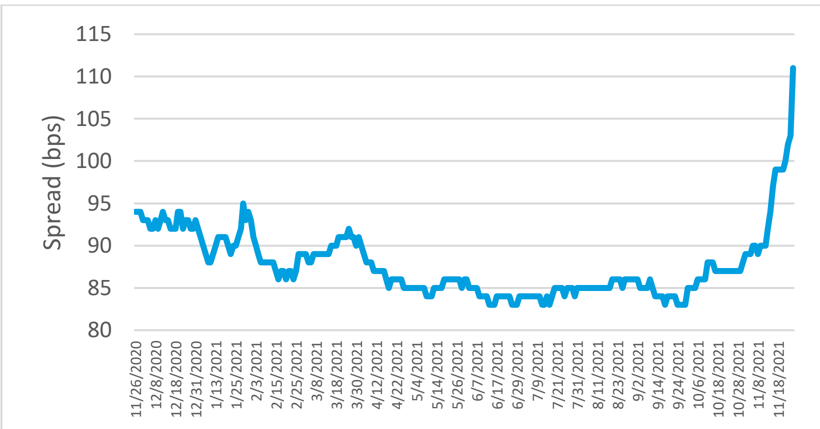
New variant of Covid leads to 'risk off'.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	1.54%	-1 bps	0.6%	-2.1%
German Bund 10 year	-0.31%	3 bps	1.7%	-1.2%
UK Gilt 10 year	0.88%	0 bps	2.7%	-3.0%
Japan 10 year	0.08%	0 bps	0.0%	-0.2%
Global Investment Grade	105 bps	7 bps	0.0%	-1.0%
Euro Investment Grade	111 bps	12 bps	0.1%	-0.9%
US Investment Grade	101 bps	7 bps	-0.2%	-1.1%
UK Investment Grade	99 bps	5 bps	1.2%	-1.9%
Asia Investment Grade	193 bps	0 bps	0.2%	-0.3%
Euro High Yield	373 bps	30 bps	-0.5%	2.5%
US High Yield	362 bps	38 bps	-1.3%	3.2%
Asia High Yield	835 bps	28 bps	0.2%	-12.0%
EM Sovereign	354 bps	28 bps	-1.6%	-3.0%
EM Local	5.8%	6 bps	-3.3%	-10.7%
EM Corporate	317 bps	14 bps	-0.4%	0.6%
Bloomberg Barclays US Munis	1.1%	0 bps	0.7%	1.2%
Taxable Munis	2.2%	-4 bps	1.0%	2.7%
Bloomberg Barclays US MBS	33 bps	4 bps	-0.2%	-1.1%
Bloomberg Commodity Index	214.87	-2.2%	-3.1%	28.3%
EUR	1.1283	0.2%	-2.1%	-7.4%
JPY	113.38	0.6%	0.6%	-8.9%
GBP	1.3347	-0.8%	-2.5%	-2.4%

Source: Bloomberg, Merrill Lynch, as at 29 November 2021.

Chart of the week: Euro IG Credit Spread – LTM



Source: Bloomberg,Columbia Threadneedle Investments, as at 29 November 2021.

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Macro / government bonds

It was expected to be a fairly quiet week in core markets with the Thanksgiving holiday in the US. However, the emergence of new strain of the Covid virus reawakened fears of lockdowns and economic slowdown. This created a bid for 'risk-free' assets such as US treasuries, which rallied strongly at the end of the week, amid less liquid conditions. It appears this variant, dubbed Omicron, is more transmissible than other strains, though at this stage its severity has not been established. Ahead of the holiday, President Joe Biden surprised few people with his reselection of Jay Powell as Chair of the US Federal Reserve. Does this matter? Probably not much, though he is seen by the market as a little more hawkish than colleague Lael Brainard, who will now become the Deputy Chair. Minutes from the last meeting of the Federal Reserve suggest the central bank is open to increasing the pace of tapering of asset purchases. This reflects a worsening in inflation data and the lowest jobless claims numbers since the late 1960s. As the Fed appears to be becoming more hawkish so interest rate expectations have risen which has supported the US dollar.

In Europe, attention has also focused onto the spread the Covid virus. This has led to a variety of government responses, for example, the reintroduction of a lockdown in Austria.

Investment grade credit

As we approach the end of the year, credit spreads continue to drift wider, led by euro-denominated swap spreads and the emergence of the new variant of COVID. This has meant that Euro IG government spreads are the widest level since October of last year and now over 110bps see **(see Chart of the week)**. US dollar and sterling markets have also weakened, but not to the same extent.

High yield credit

European High Yield (EHY) also had another down week, performance wise, as spreads widened 30bps to 373bps with CCCs only marginally outperforming BBs and Bs. EHY, especially the travel sector, was hit hard on Friday, given the latest Covid variant news. It still experienced inflows, in spite of the market weakness, though solely due to managed accounts as ETFs continued to experience redemptions. Primary market activity was light given the Thanksgiving break in the US. Only two issuers came to the market: UGI int'l and Renault, for a total €900m issuance, taking the year-to-date tally to €148bn for corporates, already almost 50% greater than 2020's total.

Credit rating wise, the EHY market continues to move from strength to strength as JPMorgan lowered its default outlook for 2022 from 1.25% to 0.75%. The more positive rating outlook for the market was reaffirmed given the number of rating improvements announced in the last weeks. Examples include Volvo (stable to positive by Moody's, at Ba1) and Verallia upgraded by Moody's to Ba1 on solid 2021operating performance, above expectations. Of course, activity was not all one way as S&P downgraded Safari (games) from CCC+ to CCC with increased risk of default while Telecom Italian's rating was lowered to BB by S&P.

In M&A news, there were more confirmed suiters for Telecom Italian as it looks like private equity groups, KKR and CVC, are joining forces to bid for the company. Ardagh, the glass manufacturer, also announced the acquisition of Consol, the South African glass manufacturer for $1bn, but still leaving the firm a substantial cash position to potentially pay-off some upcoming bonds.

Asian credit

Kaisa has launched a bond exchange offer for its $400m KAISA 6.5% bonds, which mature on 7 December 2021. The acceptance level is set at 95% for the exchange to new 6.5% notes that mature on June 2023. China Aoyuan has reportedly defaulted on CNY66m of trust loans, issued by a subsidiary which it guarantees. Moody's has also downgraded China Aoyuan from B2 to Caa2 with a negative outlook due to the company's heightened liquidity and refinancing risks.

In the consumer internet sector, the launch of Tencent's new apps and the updates of existing apps are subject to further views by the MIIT (Ministry of Industry and Information Technology), which could last till year-end. Tencent stated that it is upgrading its apps to comply with the new Personal Information Protection Law (PIPL).

Emerging markets

Emerging market hard currency spreads widened 28bps on the week as the omicron variant shocked the markets. Angola was one of the worst performers, driven by the sell-off in oil prices. The index sell-off was the largest seen since the initial March 2020 Covid decline.

The Turkish Lira sold off over 9% against the US dollar last week and is extending this decline as of Monday morning. The falls comes as Istanbul ordered Erdoğan regime critical philanthropist, Kavala, to remain in jail, a situation that's causing tension with western powers. Turkey lowered interest rates on 18 November, while inflation is expected to exceed 20% in its next CPI release. President Erdoğan sees the Lira sell-off as positive as he believes this will improve job prospects and international competitiveness.

EM currencies have been under pressure on aggregate over the last few weeks (-0.62% last week), partially driven by US dollar strength and Covid concerns. Rate hikes last week from the Dominican Republic (+50bps), South Korea (+25bps), Sri Lanka (+25bps) and Ghana (+100bps) did little to temper the decline.

In more positive news S&P have raised Bahrain's credit outlook to stable as a result of ongoing fiscal reforms.

Commodities

WTI was down 10.3% on the week (13.1% on Friday) driven by concerns over the omicron variant. The market is currently pricing in four million barrels per day of demand destruction, due to disrupted industrial activity and travel restrictions being imposed to varying degrees around the globe. OPEC have delayed technical meetings to further assess the demand impact.

Natural gas rallied 6.5% last week driven by a combination of widespread colder temperature forecasts in Europe, LNG cargos continuing to go to Asia and a lack of supply relief from Russia. Despite the risk off sentiment all precious metals were down between 3.6% and 14.2% last week due to dollar strength. Palladium was the worst hit due to the additional concern of falling industrial demand.

Wheat prices were resilient on the week with the Kansas contracts rallying 3.6% due to ongoing tight supply. Prices remain at multi-year highs.

Responsible investments

Last week, the Bank of England began enforcing green criteria when purchasing corporate bonds. Standards will need to be met on ESG factors before being bought, and a scorecard will be created for each issuer with details of these factors, which will be made available to all investors. The European Central Bank is expected to follow suit with a similar process.

As we approach the last month of the year, the ESG bond universe as passed $1trn in issuance, according to Bloomberg. As a reminder, only $480bn was issued in the full year 2020. Over half of the issuance this year has been in green bonds, as nations and large companies are fighting to meet their promises of becoming net-zero on carbon emissions in the years and decades to come. If you'd like to read about why hydrogen is playing an important part in the race to become net-zero, please read our latest thought piece from resident RI Senior Analyst Dr Ben Kelly on the topic. https://www.columbiathreadneedle.co.uk/en/intm/insights/green-hydrogen-is-finally-showing-its-true-colours/

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views
29th November 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	▪ 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 ▪ 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	▪ 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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