INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

22 MARCH 2021

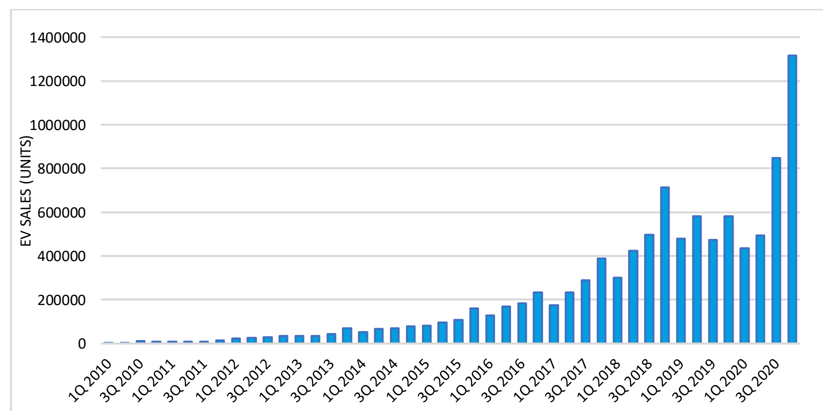
Together in electric dreams.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.67%	5 bps	-1.3%	-4.7%
German Bund 10 year	-0.31%	0 bps	-0.1%	-2.5%
UK Gilt 10 year	0.82%	0 bps	0.1%	-7.4%
Japan 10 year	0.08%	-4 bps	0.6%	-0.6%
Global Investment Grade	99 bps	-1 bps	-1.2%	-3.6%
Euro Investment Grade	91 bps	2 bps	0.1%	-0.8%
US Investment Grade	100 bps	-2 bps	-1.9%	-5.0%
UK Investment Grade	96 bps	2 bps	-0.4%	-4.3%
Asia Investment Grade	204 bps	-3 bps	-0.5%	-0.9%
Euro High Yield	329 bps	6 bps	0.2%	1.2%
US High Yield	367 bps	12 bps	-0.8%	0.0%
Asia High Yield	544 bps	-16 bps	0.3%	0.9%
EM Sovereign	316 bps	-11 bps	-0.6%	-4.3%
EM Local	4.9%	7 bps	-1.3%	-5.0%
EM Corporate	296 bps	-7 bps	-0.6%	-0.7%
Bloomberg Barclays US Munis	1.3%	11 bps	0.2%	-0.8%
Taxable Munis	2.5%	4 bps	-2.5%	-5.0%
Bloomberg Barclays US MBS	15 bps	4 bps	-0.6%	-1.2%
Bloomberg Commodity Index	179.99	-1.7%	-0.9%	8.3%
EUR	1.1918	-0.4%	-1.4%	-2.6%
JPY	108.71	0.1%	-2.1%	-5.1%
GBP	1.3863	-0.4%	-0.4%	1.5%

Source: Bloomberg, Merrill Lynch, as at 19 March 2021.

Chart of the week: Electric vehicle sales, 2010-2020



Source: Bloomberg, Columbia Threadneedle Investments, as at 17 March 2021.

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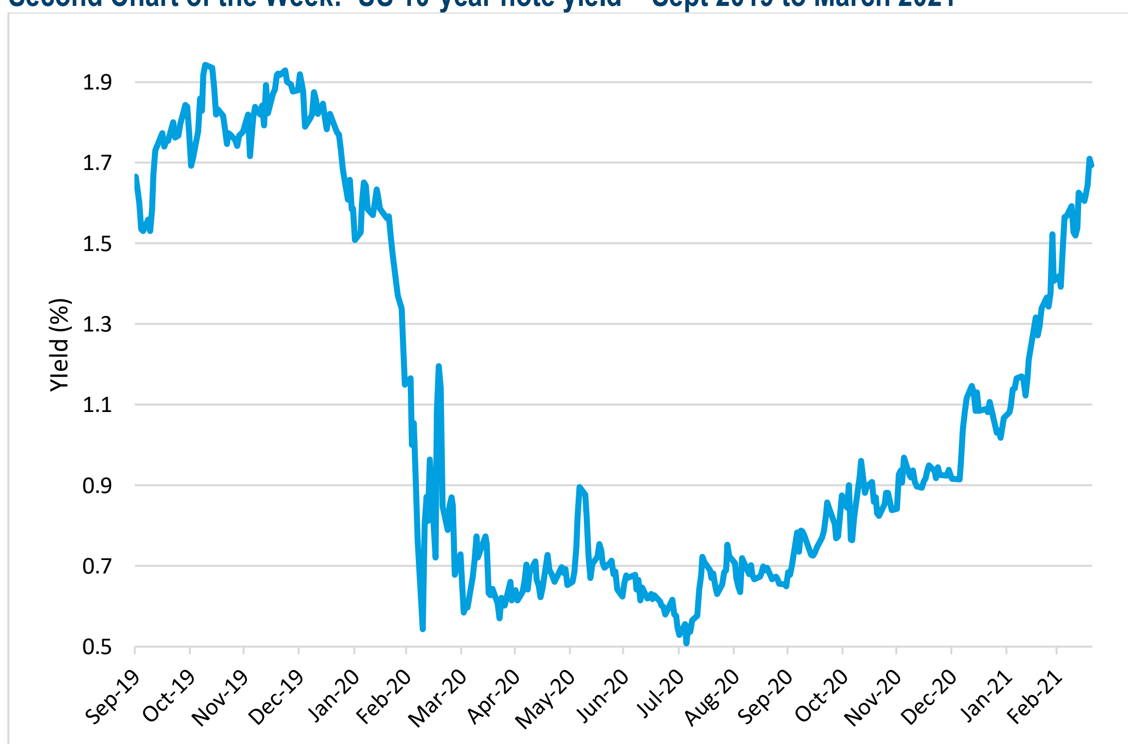
Macro / government bonds

Core government bond markets remain in a nervous state. The good news about the vaccination roll out (UK and US), the passage of the US fiscal package, the concurrent rise in growth expectations and normalisation of the inflation outlook have conspired to take yields close to where they were before most had even heard of the virus in early 2020 **(see second chart of the week).**

From here, we are less concerned about inflation expectations that are now above the average rate of inflation seen in the last 20 or so years. A greater risk to markets might seem to come from real yields, which are still very low (indeed negative). Market yields have come a long way in a short period of time, and we find these levels/yields attractive. The recently announced lockdowns in France and spike in case count in Germany are illustrative that the path to normalisation still has potholes.

Second Chart of the Week: US 10-year note yield – Sept 2019 to March 2021



Source: Bloomberg, Columbia Threadneedle Investments, as at 17 March 2021.

Last week, the US Federal Reserve met and updated its economic forecasts and interest rate expectations, which proved to be more 'dovish' than market expectations. The Fed upgraded its outlook for growth this year materially from 4.2% to 6.5% (post fiscal stimulus and vaccine roll out). Unemployment is expected to decline to 5.7% this year from 6.2% presently and to 4.1% in 2023. In terms of inflation (the key focus for markets this year), the Fed sees a 'blip' higher in prices to 2.4% this year before returning to around 2%. It doesn't expect rates to rise in the next few years, which is less hawkish than market expectations of around three rate hikes in 2023.

In data news US retail sales fell by a (weather-related) larger amount than expected though the prior month's sales were revised higher. Industrial production was also weaker as were housing starts – again weather related. Lastly, initial jobless claims came in higher than expected last week at 770k (exp 700k).

Investment grade credit

Credit spreads were little changed last week despite the ongoing sell-off seen in government bond markets.

In news, European car sales plunged by over 19% y/y in February. Of the major manufacturers, BMW was one of the 'least bad' down only 13% while others such as VW (-19%), Stellantis (-22%) and Renault (-29%) fared less well. BMW also released its earnings last week, detailing that margins would double from last year to around 6-8% (c.f. VW expects 5%). The manufacturer noted that they expect around 50% of vehicles to be electric (EVs) by 2030 (c.f. VW 60%). VW also published its results and indicated that around 10% of its sales were EVs last year, up from less than 2% the previous year. The rise in global EV sales is plotted in the **chart of the week** (with thanks to Dr Ben Kelly from our Responsible Investment team).

In the UK, The National Grid announced plans to buy the UK distribution business of PPL (Western Power Distribution). It will fund this acquisition, in part, through selling a US business (Narragansett). and reducing its gas transmission footprint. The chief strategic reason for this transaction is the shift from fossil fuels to electricity distribution: the energy transition theme.

US structured credit

The Agency MBS market underperformed last week posting a negative return of 36bps versus the Bloomberg Barclays Aggregate Bond Index, which fell 28bps. Generally, a lack of demand and overall selling from yield seekers put pressure on the market. Continued strong housing data and a high level of cash-out refis are expected to support supply in the year ahead; however, mortgage applications have been choppier recently. In CMBS, spreads widened month-on-month on higher market volatility and mixed flows. The delinquency rate in CMBS is currently pacing at a slight uptick over February at 7%.

High yield credit

US high yield bond prices declined over the week amidst equity volatility, sharply higher interest rates and lower commodity prices. The S&P 500 returned -0.61% while the 10-year US treasury yield surged 17bps w/w to 1.71%, a high since early 2020. Oil (WTI) prices declined -$6.02 (-9.1%) to $60.00, its lowest level since 19 February. The ICE BofA US HY CP Constrained Index returned -0.53% and the yield-to-worst increased 16bps to 4.51%. According to Lipper, the asset class reported a $410 million inflow over the week.

European high yield had a weaker tone last week as spreads widened 6bps to 329bps. Longer-duration bonds especially suffered as inflation concerns weighed heavily on the market, despite the ECB's ramped up bond buying. Still, ETF buying returned to the market and was the sole reason behind last week's inflows of €78 million. It was a heavy primary issuance week with €5.5 billion of bonds (Gamenet, British Airway, Faurecia green bond, CGG) bringing the year-to-date total to €38.1 billion, 50% higher than historically.

Credit rating agencies are expressing a more positive stance overall given the number of improvements in outlook (ex. Faurecia, Synlab, Grupo Antolin) to rating upgrades (ex. EDP hybrids, Avantor) recently announced. Good cost discipline, dividend suspension, and deleveraging focus were some of the reasons cited. Special note for the auto sector where S&P has moved to a more positive outlook reflecting the sector's recovery and cost cutting actions taken during the pandemic.

This could mean a lot more rising stars, starting in 2022, so long as the auto names retain their deleveraging focus. Recovery in gaming was also noted, especially due to the resilience in lottery. Given the lower duration outlook for 2021, this relative improved stance is a strong indication how well, with central bank and government support, the market has turned around from the worst expectations of last year.

Leveraged loans

The asset class posted its 10th consecutive weekly inflow, with a $997 million contribution. The average price on the J.P. Morgan Leveraged Loan Index decreased -$0.16 to $98.15 over the week and is now $0.31 below the year-to-date high on 24 February. The month-to-date return for the index is -0.01% with Split B/CCC loans (+0.62%) outperforming Bs (-0.04%) and BBs (-0.26%).

Asian fixed income

Moody's revised the outlook on Sunac China Holdings' Ba3 rating to positive due to its expectation that Sunac's leverage will improve over the next 12-18 months and the company will remain prudent in land acquisitions. Sunac has reduced its annual land acquisitions to 20% of attributable contracted sales in 2020 (prior year: 32%).

Moody's cut Sritex's B1 ratings to "review for downgrade" due to the delay in obtaining a 2-year extension for its $350 million syndicated loan due January 2022. While management stated that the company has made good progress in negotiations with its bank lenders, there is no official disclosure yet about the extent of approvals from the syndicate of banks. Earlier in February, its key relationship banks (Citibank, DBS) have reportedly approved the facility extension by another two years. Sritex was also seeking to get several domestic banks to participate as new lenders to replace other banks that are not extending the bank loans.

CK Hutchison (CKH) reports FY results that are in line with market expectation. FY revenue fell to HK$403.8 billion (-8% y/y) and EBITDA was HK$96.9 billion (-13%). CKH's ports and retail businesses recovered in H2,20 after the weak H1,20, but the operating performance of Husky Energy remained difficult. CKH said it will assess potential share buybacks, with the proceeds of selling its tower businesses in Europe. The company completed the disposal of its tower business in Austria, Denmark and Ireland for €2.2 billion in December 2020. The tower business disposal in Sweden was completed for €800 million in January 2021 and CKH targets to complete the disposal of its Italy Tower business in Q2, 21. The net debt/capital ratio was 22.2% in FY20 (-2.6ppt y/y) and management expects this ratio to improve further in FY21, with the completion of the disposals.

Emerging markets

Emerging market debt had a stronger week with spread compression within both the sovereign and corporate markets. EM local delivered a small positive return (+0.5%) driven by EM FX appreciation.

Turkey grabbed the headlines last week with a 200bps interest rate hike, exceeding the 100bps market expectation. This was received positively by the market, given the latest 15.6% CPI print. Later in the week, Turkey's central bank governor Agbal was dismissed by President Erdogan, after only four months of service. Agbal was favoured by the market following criticism that the central bank was too dovish. The replacement, Kavcioglu believes hiking rates will hurt economic

growth and mainly benefit foreign investors. Elsewhere, Russia unexpectedly hiked interest rates 25bps to 4.5% while Brazil also raised rates by 75bps to 2.75%.

In corporate news, the Mexican government announced it will absorb the $6.4 billion debt repayments of Pemex this year. Pemex is tasked with reducing Mexico's energy import dependency; however, the company's debt is the highest of any major oil company.

Commodities

The commodity index experienced its first correction last week following a strong start to 2021.

The decline was driven by energy markets, with crude and crude products falling in tandem with Brent down 5.9%. This coincided with the latest lockdown announcements from Europe. However, some market participants see the move more as the product of rebalancing in macro funds with Goldman Sachs describing the move as transient.

In agriculture, corn was the best performer on the week rallying by 3.5%. This was driven by China purchasing 4 million tonnes of corn, a much higher amount that usual. Though there is uncertainty as to why China continues to buy corn at recent higher prices, there is talk the country could be facing domestic shortages due to a lack of suitable farmland.

Responsible investments

On Tuesday last week we saw France issue its second Sovereign Green Bond. The sale took a record €34.5 billion in orders. It's over 50% more than they took in its first green bond sale back in 2017. The sale ended up raising €7 billion and keeps France top of the table in total Green Bond issuance in history. Use of proceeds are to go towards environmental projects. As we near the end of Q1 2021, total Green Bond issuance stands at $119 billion, we're now only $11 billion away from meeting half of 2020's total issuance and we're only 3 months in!

A UK based start-up, Deep Branch has received support from multiple investors, including oil company Total to scale up a fermentation method that will turn carbon dioxide emissions into feed for chickens, pigs and fish. Deep Branch use a process similar to the fermentation stage in winemaking, except instead of the microbes feeding on sugars, they feed on hydrogen and carbon dioxide to produce proteins. This effectively results in an extremely low carbon footprint. They are not completely alone in doing this as other firms in the US, China and Finland are also looking into fermentation technology to turn harmful gases into proteins.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

22nd March 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 better than they went into the pandemic. ■ 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. ■ Question marks on the sustainability of super easy financial conditions, inflation, & the labour market widen the range of outcomes for spreads in one year's time.	■ Rapidly rising Treasury yields tighten financial conditions or make all in yields of credit less attractive. ■ A recovering economy propels spreads to all-time tights, especially if vaccinations accelerate quickly ■ Geopolitical tensions rise above a simmer, particularly in the US China relationship, which has not meaningfully improved with a new US Administration.
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long £ €	■ Pandemic scarring likely to keep growth subdued ■ Reflation credibility still low, although risks from fiscal policy ■ 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	■ 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$ $	■ US growth outperformance on back of fiscal stimulus boosts USD ■ ECB increasingly sensitive to Euro appreciation	■ Vaccine rollout in Europe improves and narrows growth gap ■ Failure to pass substantial fiscal package in US
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ Favourable advanced economy policy settings support EM assets in near term ■ EM real interest rates relatively attractive, curves steep	■ Sharp escalation in global risk aversion ■ 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). ■ Index composition changes over the last 5 years have added a lot of duration to the sector, leaving it vulnerable. ■ 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 ■ Growth scars from COVID persist and hurt commodity prices & ability to grow out of deficits. ■ 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%. ■ 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. ■ 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. ■ 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. ■ Access to capital remains easy even through more volatile markets of late, and a return to normalcy disproportionately benefits low-quality credits. ■ 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. ■ 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. ■ Fed buying cannot be expected to increase in 2021, exposing negative fundamentals and valuations ■ 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. ■ The Fed maintains or increases MBS purchases next year.
Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ 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 pockets of value still exist. ■ CMBS: a return to normalcy won't look 'normal' for sectors like office space or convention hotels, but pockets of value still exist in these and other areas (but there are simply fewer opportunities than 6 months ago) ■ Our preference remains for non-agency RMBS in this area.	■ 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). ■ Rising interest rates may dent housing market strength, butseems unlikely to derail it.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	■ o/w Copper vs Aluminium ■ o/w Lead vs Zinc ■ o/w Soybeans ■ u/w Livestock	■ US China trade war

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