INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

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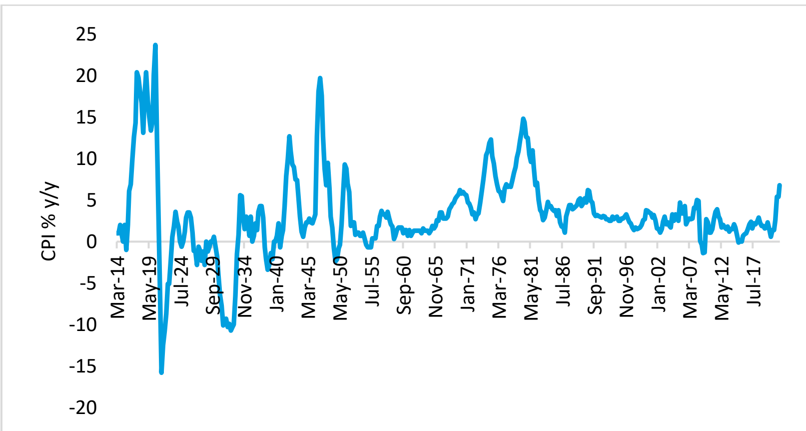
What went up…must come down (hopefully)!

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	1.47%	13 bps	-0.6%	-2.4%
German Bund 10 year	-0.36%	3 bps	-0.1%	-1.1%
UK Gilt 10 year	0.72%	-3 bps	0.8%	-1.9%
Japan 10 year	0.05%	0 bps	0.0%	0.0%
Global Investment Grade	101 bps	-4 bps	-0.1%	-0.9%
Euro Investment Grade	99 bps	-5 bps	0.5%	-0.4%
US Investment Grade	100 bps	-3 bps	-0.4%	-1.1%
UK Investment Grade	99 bps	0 bps	0.7%	-1.2%
Asia Investment Grade	189 bps	-5 bps	-0.2%	-0.2%
Euro High Yield	354 bps	-15 bps	0.7%	3.2%
US High Yield	329 bps	-27 bps	1.1%	4.5%
Asia High Yield	822 bps	-50 bps	1.0%	-11.6%
EM Sovereign	329 bps	-20 bps	1.4%	-1.5%
EM Local	5.6%	-4 bps	1.1%	-9.1%
EM Corporate	315 bps	-12 bps	0.4%	0.9%
Bloomberg Barclays US Munis	1.1%	1 bps	0.1%	1.4%
Taxable Munis	2.3%	13 bps	-1.1%	1.8%
Bloomberg Barclays US MBS	33 bps	-5 bps	-0.2%	-1.2%
Bloomberg Commodity Index	207.49	1.2%	1.1%	24.2%
EUR	1.1266	0.0%	-0.2%	-7.4%
JPY	113.68	-0.5%	-0.2%	-8.9%
GBP	1.3244	0.3%	-0.2%	-2.9%

Source: Bloomberg, Merrill Lynch, as at 13 December 2021.

Chart of the week: US Consumer Price Inflation, 1914-2021



Source: Bloomberg, Columbia Threadneedle Investments, as at 13 December 2021.

Macro / government bonds

I wonder if anyone at the start of the year would have predicted that US inflation would have risen to 6.8% y/y in November? If we had expected this, you would have thought that bond yields would have traded at less than 1.5% at the 10-year point on the curve. Probably not we imagine.
So, headline consumer price inflation came in at nearly 7% y/y and is the highest print since the early 1980s **(see chart of the week).** Even the core (ex-food and energy) reading was elevated to a 4.9% y/y rate of growth. This was not as 'bad' as some forecasters had predicted.

Inflation has persisted as the key theme all year. We believe the factors that have driven inflation so high are generally behind us. Firstly, there is the starting point or base line effect, which was very low. Recall that US CPI was growing at 0.1% y/y in May of last year. Secondly, the effect of the reopening of economies. That is over and indeed threatened by the Omicron Covid variant and we see the consumer weakening into next year. Thirdly, the accompanying supply chain shortages (such as microchips for cars), which again seems to be gradually resolved, though the 'flip-side' of Omicron may see a remergence of this problem. Lastly, surging commodity prices, including oil and natural gas. Again, the news is encouraging with oil off the highs and US natural gas futures prices down nearly 40% from their peak in early October. There do remain shortages of labour, especially in so called 'face to face' jobs (eg, restaurants) and there is the risk of further rises in wages here. But margins are skinny and if the Omicron virus forces further disruption then it is hard to imagine these types of companies can afford to pay much more.

The long-term secular forces of inflation suppresion also seem to remain intact. Globalisation and lowest cost production is still with us. Deunionisation and its effect on collective bargaining weakens the hand of some areas of the labour force. Technology and its effects, including price transparency, have only increased since Covid as shopping continues to move from store to online. Meanwhile, ageing populations mean a lower propensity to spend than save; all the while debt levels weigh on consumers just at a time when interest rates and policy conditions seem to be heading in the wrong direction.

This week brings central bank meetings in the US, Europe and the UK. Most expect the Federal Reserve will up the pace of asset tapering and present a median prediction of two interest rate rises in 2022. The ECB is likely to be more dovish, with its models suggesting inflation will be below target again in 2023/24. Meanwhile, the Bank of England's actions hang in the balance though we expect them to wait before raising rates as the effect of Omicron unfold.

Investment grade credit

The last week has seen investment grade spreads show some signs of stability after the weakness in November and early December. As we end the year, the difference between the widest and narrowest spread has still been astonishingly tight. Spreads peaked at 106bps a week or so ago and were at their tightest at the end of September at 88bps: all in, a range of only 18bps. Compare this to last year where the range was over 240bps.

Valuations remain expensive, but not hugely so. At present, spreads are around 0.5 standard deviations rich to the 20-year average. It is, however, common for spreads to trade on the 'wrong' side of fair value with infrequent but violent spikes wider (GFC, eurozone / Covid crises). On the fundamental side, a theme that seems worth watching is the increased involvement of private equity in companies as well as heightened M&A activity. These are often late cycle phenomenon so we urge a cautious approach even as corporate balance sheets improve in aggregate and consumers seem in relatively good shape.

On a standalone basis we feel fairly neutral on the direction of spreads into the New Year but are building portfolios with a skew towards more stable industries such as regulated utilities.

High yield credit & leveraged loans

US high yield bonds had their biggest weekly rally of 2021 as concerns about the severity of the Omicron variant receded. The ICE BofA US HY CP Constrained Index returned 0.63% and spreads were 27bps tighter over the week. According to Lipper, the asset class reported $1.3bn of inflows. Leveraged loan prices also increased $0.25 over the week. The asset class did post only its third weekly outflow in the last 48 weeks with a modest $50m withdrawal for the week.

It was another strong week for European High Yield (EHY) as spreads tightened in 15bps with single Bs strongly outperforming both BBs and CCCs (the latter credit rating bucket being the only one to post a negative performance for the period). Still, the asset class experienced another week of outflows (€440k), this time solely from managed accounts. It was also another quiet week for the primary market with only one issue from T Mobile, Netherlands (€1.35bn) to fund the acquisition by Apax/Warburg. The holiday lull is starting to set in with low market liquidity and new issuance being delayed until the new year.

In M&A news, shipping company CMA CG announced the acquisition of the majority of Ingram Micro's Commerce & Lifecycle Services business for the equivalent value of $3bn. The business specialises in eCommerce logistics and generates c$1.7bn in revenues which, when combined with CMACG's CEVA Logistics operations, will create the fourth largest contract logistics provider globally. There is more and more talk of the number and size of potential M&A deals in 2022 and its impact on the EHY primary market. Could be as large, if not greater, than the high seen in 2007.

Structured credit

The US Agency MBS market posted negative total returns last week in sympathy with high quality fixed income, with the sector down 21bps. Mortgages are repricing to a faster taper which is the expectation from this week's FOMC's meeting. November prepay speeds came in slower than prior months driven by a slightly higher mortgage rate and lower seasonality. Speeds slowed down most drastically on lower coupons near current origination across both agency and term. While net issuance for the YTD period is at a record-breaking $799bn, November gross issuance fell to $243bn, the lowest gross issuance print since April 2020. ABS spreads were firm last week on strong buyer demand. The US consumer remains well positioned with fundamentally strong performance. In CMBS, most segments remain strong with low defaults. Demand remains firm for senior tranches with below IG tranches 30-40 wider on year-end selling.

Asian credit

Fitch cut the ratings of Evergrande Group and its subsidiaries (Hengda and Tianji) from "C" to Restricted Default due to the non-payment of the coupons for two bonds after the grace period lapsed on 6 December. Following Evergrande's announcement that it will engage with offshore creditors to formulate a viable restructuring plan, various government institutions and regulators (PBOC, CBIRC, CSRC and the Ministry of Housing and Urban-Rural Development) have stepped in to assure the market that the contagion risks to the capital markets and financial institutions are contained. The PBOC also cut the RRR by 0.5ppt to 11.5%, which will be effective from 15 December 2021.

Kaisa Group was also cut by Fitch to Restricted Default after the company failed to pay the $400m on the KAISAG 6.5% note at maturity on 7 December. A group of bondholders of the KAISA bonds has also sent a formal forbearance proposal and other financing proposals to the company.

Emerging markets

In China, the market was supported by government pledges of policy support to drive growth next year. Consensus forecast for Chinese GDP growth is 5.3% for 2022 down from 8% for 2021. China's November PPI came at 12.9% YoY with CPI at 2.3%, rising from 1.5% in October. Brazil hiked interest rates 150bps to 9.25% as widely expected. This marks the seventh hike of 2021 as Brazilian inflation crept into double digits. Brazil has faced criticism for high fiscal spending on its social programmes. Elsewhere in Latin America Peru hiked rates by 50bps. In Eastern Europe, Poland and Ukraine hiked 50bps and Hungry hiked 20bps to 3.3%.

US president Biden spoke with Russian president Putin last week warning of "devastating consequences" if Russia invades Ukraine. The US have pledged to support Ukraine with weapons, while Ukraine has already received US Javelin anti-tank missiles.

Commodities

Zinc prices rallied 5.4% las week following Glencore's announcement to close one of its European 100,000 tonne per year plants. This follows previous European closure announcements from Glencore and Nyrstar. Zinc, like aluminium, is highly energy intensive and production has been hampered by rising energy prices. Europe accounts for 16% of global zinc production.

WTI rallied 8.2% on the week as the market expect to have a lesser impact on global fuel demand due to lower lethality. The market was also supported by the US co-ordinated strategic petroleum release having yet to materialise. The US recently announced a release of 50 million barrels over a number of months, which is underway; however, other intended contributors such as the UK, Japan and South Korea have yet to take action. Natural gas prices fell 5% last week on reports of warmer winter weather in the US. European prices are rising as of Monday morning due to rising concern that the already completed Nord Stream 2 pipeline won't operate this winter despite cooler weather forecasts. To make matters worse European storage is only at 63% of normal levels.

Responsible investments

Last week the Biden administration took a big step in its climate fight by placing a stop to any further federal support to coal plants and other carbon-intensive projects overseas. Although this doesn't include any current or existing projects, this will have a large impact on potential foreign projects that were dependent and reliable on US funding. Volkswagen came to the market last week with its first sustainability-linked bond. The €1.8m issue is funding projects to help lower the automakers carbon emissions. This adds to the already record-breaking issuance of €156bn in sustainability-linked bonds this year: an 80% increase on 2020.

Summary of fixed income asset allocation view

Fixed Income Asset Allocation Views

13th December 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 continue to be capped by long-run structural downtrend in real yields ▪ Inflation likely to prove largely transitory ▪ Hiking cycles to be shortened by easing inflation and moderating demand ▪ ECB to lean against rising financing rates	▪ Inflationary dynamics become persistent ▪ Labour markets see broad-based wage pressure ▪ Fiscal expansion requires wider term premium ▪ Long run trend in safe asset demand reverses
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 Oil	▪ US China trade war ▪ Renewed Covid lockdowns ▪ Global Recession

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