COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

7 FEBRUARY 2022

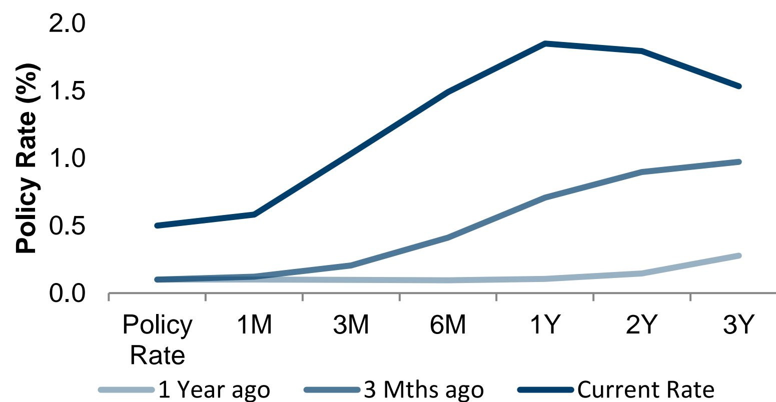
A farewell to super low discount rates.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	1.91%	14 bps	-1.0%	-2.9%
German Bund 10 year	0.22%	26 bps	-1.4%	-2.5%
UK Gilt 10 year	1.41%	16 bps	-0.7%	-4.7%
Japan 10 year	0.20%	3 bps	-0.3%	-1.0%
Global Investment Grade	111 bps	2 bps	-1.2%	-3.7%
Euro Investment Grade	114 bps	8 bps	-1.6%	-2.9%
US Investment Grade	109 bps	0 bps	-1.1%	-4.2%
UK Investment Grade	112 bps	8 bps	-1.5%	-4.4%
Asia Investment Grade	191 bps	3 bps	-0.1%	-1.6%
Euro High Yield	385 bps	14 bps	-1.2%	-2.7%
US High Yield	356 bps	-5 bps	-0.4%	-3.1%
Asia High Yield	705 bps	-18 bps	-0.1%	-4.0%
EM Sovereign	338 bps	-10 bps	-0.4%	-3.3%
EM Local	5.9%	-5 bps	0.8%	0.8%
EM Corporate	312 bps	-7 bps	-0.2%	-1.9%
Bloomberg Barclays US Munis	1.7%	-6 bps	0.5%	-2.3%
Taxable Munis	2.8%	15 bps	-1.3%	-4.5%
Bloomberg Barclays US MBS	22 bps	3 bps	-0.8%	-2.2%
Bloomberg Commodity Index	233.33	2.3%	1.6%	10.5%
EUR	1.1417	2.7%	1.9%	0.7%
JPY	115.00	0.0%	0.0%	-0.1%
GBP	1.3525	1.0%	0.6%	0.0%

Source: Bloomberg, Merrill Lynch, as at 7 February 2022.

Chart of the week: UK interest rates and expectations



Source: Bloomberg, Columbia Threadneedle Investments, as at 7 February 2022.

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Macro / government bonds

The path to more 'normal' interest rates and policy conditions continues around the world and while the prior week was all about the US central bank pointing to tighter rates in March, last week the batten was passed to its British and European cousins.

The Bank of England as expected moved rates higher with the second rate rise of this tightening phase. That said, four of nine voting members indicated a preference to tighten by 50bps. The UK base rate is now 0.5% after the 15bps rise delivered in mid-December of last year. There are more to come this year if markets are to be believed **(see chart of the week)**. Presently, the market estimates there will be another five rate rises in 2022. The BoE will now stop reinvesting the proceeds of maturing bonds it owns, which should reduce its balance sheet by around £38bn this year. There was no word, yet, on outright sales of bonds.

There was less excitement out of the more dovish European Central Bank, where rates remained anchored in negative territory at -0.5%. Eurozone inflation would not have made for easy reading at the ECB as it came in at 5.1% in January, even though core inflation was a more modest 2.3% y/y. This was noted by the ECB and the market, with two hikes now priced for the year ahead.

The week ended with the US employment report, which eclipsed expectations by a margin. The monthly increase in jobs was 467k (exp 125k) while revisions to past months were strongly positive. Wages grew more than expected (+0.7%).

Investment grade credit

Credit spreads continue to widen against the background of expected tighter monetary policy conditions and a 'risk-off' tone.

Global spreads at 111bps over government bonds are 11% wider in the year so far. Euro credit spreads have widened the most this year with the US dollar market the most stable. Liquidity was being challenged in a weak close to last week though the new issuance market remains open with Bank of America printing a large deal.

High yield credit & leveraged loans

US high yield bond prices were volatile over the week as a brief period of rate stability and equity strength was disrupted by hawkish surprises from both the BoE and ECB and a larger than expected US payroll gain. The ICE BofA US HY CP Constrained Index returned -0.26% while spreads were 4bps tighter. Strong outflows continued with a $4bn withdrawal from the asset class according to Lipper. US leveraged loans continued to benefit from the hawkish central bank landscape with prices mostly unchanged. Retail loan funds saw a $1.3bn inflow over the week.

European High Yield had its fourth down week in a row, the worst one yet for 2022. This came on the back of concerns of a more hawkish tone by central banks and concerns to what extent government balance sheets would start being unwound. ETF sales accelerated resulting in a more indiscriminate selling of the market as BBs were the worst performers for the week, underperforming lower-rated credits. ETFs are, unusually, pricing at a discount (as much as 60 cents this week). Outflows (€-289k) in the first week of February was just above that of all of January as sales picked up in ETFs as well as in managed accounts. The primary market experienced a small pick-up from the previous week with seven issues totalling €1.9bn. This takes the YTD

issuance to almost €10bn. Interestingly, unlike previous years, issuance has focused on lower-rated credits (where BBs usually led issuance in the first months of the calendar year.) For the week, the market looked more to unload some risk as even constructive days saw the market selling into strength. This was especially the case for longer-duration securities given the move in government rates resulting in a steepening of the credit curve.

In credit rating moves, Saipem the Italian utility was downgraded to B1 from Ba3 by Moody's and to BB- from BB by S&P this week. This came after the firm announced a write down on its order book and has engaged Rothschilds to work on a restructuring plan. More positively, Infineon hybrids were upgraded to BB+ from BB as the senior bonds were upgraded to BBB from BBB-.

In M&A news, it looks like MasMovil, the Spanish telecom may be in talks to buy Vodafone's Spanish unit. In the packaging sector, SIG announced it would acquire packaging company Scholle IPN for €1.49bn; this will be funded by a mix of equity and debt. This follows an earlier recent multi-million paper packaging acquisition supporting a strong acquisitions trend in the packaging sector. In the auto sector, the takeover of Hella by Faurecia was officially completed last week, creating the seventh largest automotive supplier worldwide.

Asian credit

The contracted sales in China properties continued a declining trend in January 2022. The top 100 property companies posted sales of CNY525.6bn (-39.6% y/y), which is 43% lower than the average monthly sales in 2021. The weak trend is likely to continue through February 2022 due to fewer property launches and the Spring Festival. Bharti Airtel announced it will do an early redemption of the BHARTI '23s bonds on 7 March 2022.

In Sri Lanka, the divergent positions of the central bank and the finance ministry with respect to any potential bailout package from the IMF remains in focus. The finance minister (Basil Rajapaksa) reportedly mentioned about seeking advice from the IMF, but the central bank Governor Cabraal clarified that the comment by the finance minister was only related to a routine technical assistance programme.

Structured credit

The US Agency MBS market suffered a 72bps decline last week, in-line with other duration sensitive asset classes. It was relatively quiet in the sector prior to the hawkish ECB statement and employment report on Friday which combined led mortgages to underperform. CMBS also widened on overall risk sentiment as new issuance took centre stage. Spreads widened across the quality spectrum with the lowest quality rung taking most of the beating. BBB- widened roughly 20bps on the week while AAA widened 3bps. In non-agency RMBS there has been a surge of new issuance. This dynamic alongside general market volatility has also pushed spreads wider while the fundamentals remain positive on consumer behaviour.

Emerging markets

In rating news, Ghana was downgraded by Moody's from B3 to Caa1, due to weak revenue generation and tight debt markets meaning the country is increasingly reliant on higher interest, short-maturity debt. In contrast, Fitch upgraded Angola from CCC to B-, Angola is a beneficiary of higher oil prices as oil accounts for 56% of the country's fiscal revenues.

In Pakistan, the IMF has agreed to release the next $1bn tranche of the $6bn bailout package. The bailout requires the government to withdraw subsidies on fuel and electricity, impose more discipline on public spending and take steps towards central bank independence.

In the UAE, drone and missile attacks from Yemen's Houthi militant group continue. The attacks have been largely unsuccessful thanks to UAE and US air defences. The US Pentagon recently dispatched F-22 fighter jets and missile destroyer, USS Cole, to Abu Dhabi.

Commodities

Future curves, particularly in crude, are trading steeply backwardated (inverted) indicating traders are paying a premium for immediate delivery and longer-dated contracts are providing a handsome roll return.

Commodity ETF's saw record inflows In January. Invesco's flagship $5.8bn commodity ETF saw $1.1bn of inflows. Flows have been supported by market momentum, equity market volatility and concerns regarding inflation.

Soybeans had a strong week rallying 5.7% driven by strong Chinese buying. China accounts for around 60% of global soybean imports and would usually be buying from South America this time of year; however, dry weather in key growing regions has raised the prospects of lower shipments.

Responsible investments

January marked another record-breaking start to the year in the Green Bond space, with just over $40bn being issued over the course of the month. This time last year we'd seen just over $30bn issued, according to Bloomberg. As progressive as it seems, the CEO of the Climate Bonds Initiative has said: "we need to be getting to $5 trillion a year to be making a reasonable contribution".

Pakistan is soon to raise $1bn for environmental, social and governance projects. They will join other emerging market nations, such as Mexico and Kenya, who are taking the first step in ESG bonds. Projects involve developing clean water and improving rural landscape.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

7th February 2022

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	▪ 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 economic growth, with high expectations for tightening at March FOMC. The pullback in forecasted liquidity has left opportunity for market volatility. ▪ Uncertainty remains elevated as the Omicron variant spreads, inflation fears revive, supply disruptions continue, 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: Omicron worsens. Supply chain disruptions and inflation persist to H2 2022. Simultaneous low unemployment, hiking and slowing growth could cause a sell off or recession.
Duration (10-year) ('P' = Periphery)	Short -2 -1 0 +1 +2 Long Above 0: ¥; above +1: P, $ Below +1: £, €	▪ Carry offered by front end yields now attractive ▪ Longer yields continue to be capped by long-run structural downtrends in real yields ▪ Inflation likely to normalize over medium term ▪ Hiking cycles to be shortened by easing inflation and moderating demand ▪ ECB to lean against rising financing rates	▪ Inflationary dynamics become structurally persistent ▪ Labour supply shortage persists; wage pressure becomes broad and sustained ▪ Fiscal expansion requires wider term premium ▪ Long run trend in safe asset demand reverses
Currency ('E' = European Economic Area)	Short -2 -1 0 +1 +2 Long Above 0: ¥, EM, A$ Below 0: $, £, E	▪ There is room for the Dollar to strengthen further given our belief in the US leading the economic and monetary policy recovery ▪ However, experience of past cycles suggests the Dollar fares less well at the start of a cycle, turn neutral USD for now	▪ The ECB moves to tighten monetary policy ▪ The Fed starts to push back against market pricing ▪ More expansive China credit cycle
Emerging Markets Local (rates (R) and currency (C))	Under-weight -2 -1 0 +1 +2 Over-weight Above +1: R Below +1: C	▪ Selective opportunities ▪ Aggressive Fed pricing may now open the door to selective 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	▪ Valuations are getting more attractive, although for reason ▪ DM tightening financial conditions will unevenly impact EM credit and EMFX as many countries have already responded to inflation through hikes ▪ 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).	▪ Spillover from China's credit woes or Russia-Ukraine aggression ▪ 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 DM
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.2021 Q3 earnings supported this, now looking to Q4 results. ▪ Good fundamentals, with strong balance sheet management, M&A 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 enhancing activities pick up, but most are leverage neutral.
High Yield Bonds and Bank Loans	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 Runway left in HY recovery trade rising stars ▪ Bank loans are attractive as they have shown better performance relative to corporates, although flows amid hiking expectations have increased valuations ▪ The best performing parts of these sectors have been the most volatile and lowest quality. ▪ Defaults are set to continue near historic lows due to the rapid recovery and ability to remove near-term maturities by companies across the credit spectrum.	▪ The reach for yield continues to suppress spreads, although mounting negative headwinds (inflation, supply disruptions) are increasing pressure for higher yields. ▪ Waves of ratings upgrade begin to occur into this year. ▪ There are few exogenous shocks that shake the tight spread environment.
Agency MBS	Under-weight -2 [■ -1] 0 +1 +2 Over-weight	▪ Overall, the risk/reward mix remains asymmetric. ▪ Valuations continue to widen on hawkish language; however, valuations remain rich and carry in many Specified Pools and CMO deals remain unattractive. ▪ Spreads still tight to similar Fed taper and QT regimes ▪ The Fed's taper was well advertised and saw a muted market reaction upon official announcement.	▪ Housing activity slows considerably and prepays move back down to normal levels, without denting households' ability to service mortgages. ▪ Uncertainty the Fed taper schedule and long-term position
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 [■ +1] +2 Over-weight	▪ Our preference remains for Non-Agency RMBS and CLOs ▪ Spread tightening seems somewhat excessive per credit quality but seeing repricing risk premiums in new issues. ▪ Keeping an eye on sentinel slight upticks in defaults ▪ RMBS: Housing continues to outperform in the recovery with constrained supply and strong balance sheets & demographics. Affordability waning but near average. Anticipating more supply in 2022. Valuations less compelling but offer stable carry in de-risked portfolios. ▪ CMBS: Most segments maintain strong fundamentals with retail & hospitality improving. Spreads outperforming other structured segments. ▪ CLOs: Attractive with fundamentals, waiting for issue pickup	▪ Attractive shorter duration deals coming into market, provide less carry ▪ 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). ▪ SOFR transition slows CLO new issuance ▪ 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	▪ Renewed Covid lockdowns ▪ Global Recession

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