COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

In Credit

14 FEBRUARY 2022

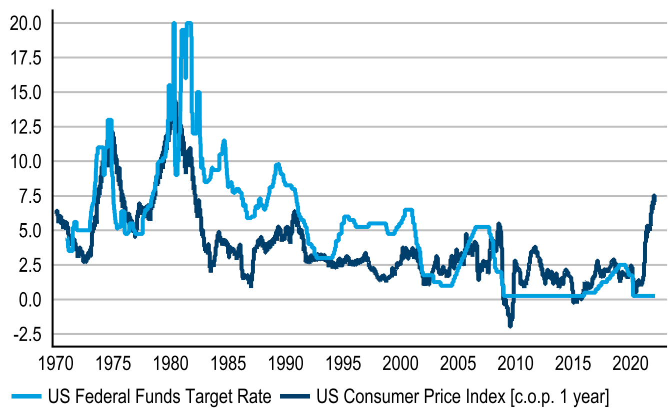
A recalibration game.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	1.93%	2 bps	-1.4%	-3.3%
German Bund 10 year	0.20%	0 bps	-2.1%	-3.2%
UK Gilt 10 year	1.47%	6 bps	-2.2%	-6.2%
Japan 10 year	0.22%	2 bps	-0.7%	-1.5%
Global Investment Grade	114 bps	3 bps	-1.7%	-4.2%
Euro Investment Grade	120 bps	6 bps	-2.1%	-3.4%
US Investment Grade	110 bps	1 bps	-1.6%	-4.7%
UK Investment Grade	111 bps	-1 bps	-2.2%	-5.1%
Asia Investment Grade	190 bps	-1 bps	-1.1%	-2.6%
Euro High Yield	395 bps	10 bps	-1.6%	-3.1%
US High Yield	366 bps	10 bps	-1.2%	-4.0%
Asia High Yield	698 bps	-7 bps	-0.3%	-4.2%
EM Sovereign	349 bps	11 bps	-1.4%	-4.2%
EM Local	6.0%	9 bps	1.4%	1.4%
EM Corporate	320 bps	8 bps	-0.7%	-2.4%
Bloomberg Barclays US Munis	1.9%	19 bps	-0.4%	-3.2%
Taxable Munis	2.9%	5 bps	-1.5%	-4.6%
Bloomberg Barclays US MBS	26 bps	4 bps	-1.3%	-2.8%
Bloomberg Commodity Index	235.69	0.3%	1.9%	10.8%
EUR	1.1309	-0.9%	1.0%	-0.2%
JPY	115.12	-0.2%	-0.3%	-0.3%
GBP	1.3499	0.2%	0.9%	0.2%

Source: Bloomberg, Merrill Lynch, as at 14 February 2022.

Chart of the week: US Consumer Price Inflation vs Fed Policy Rate



Source: Macrobond, Columbia Threadneedle Investments, as at 14 February 2022.

David Oliphant

Executive Director,
Fixed Income

Contributors

David Oliphant
Macro / Government bonds, Investment Grade Credit

Angelina Chueh
Euro High Yield Credit

Chris Jorel
US High Yield Credit, US Leveraged Loans

Katherine Nuss
US Investment Grade Credit

Kris Moreton
Structured Credit

Justin Ong
Asian Fixed Income

Doug Rangel
Municipals

Charlotte Edwards
Responsible Investments

Jake Lunness
Commodities
Emerging Markets

Macro / government bonds

The bond market sell-off has undermined total returns in most areas of fixed income and indeed equities this year. Last week's move higher in yields added to that particular misery.

On Thursday last, CPI data in the US came in higher than the already high estimates and at 7.5% y/y. You would need to go back to the early 1980s to uncover a similar such outcome **(see chart of the week)**. That was a time when interest rates were closer to 10%, in stark contrast to today's near zero Federal Funds rate. The data release had predictable effects as real and nominal yields rose. Short-dated bonds underperformed, in a flattening of the yield curve, while future expectations of interest rates rose again, which in turn helped the US dollar move upwards. Each week this year seems to bring a recalibration of when enough interest rate increases will be enough. Market pricing, according to Bloomberg, suggests that the US Federal Reserve will raise rates around seven times between now and February 2023, taking the implied policy rate to around 1.75% by that date.

So, a historically sharp increase is already discounted. If 1.75% was to be the terminal rate in this cycle it would only be around 0.3% higher than the average for the last 20 years. That is a period that included a fair fistful of crises (GFC, eurozone, energy, Covid-19 etc). Going back to 1970 (when inflation was more prevalent) that average number rises to 5%. It's all a matter of historical context.

As we have mentioned, it is notable that the sell-off in US bonds this year has been more than 100% explained by rising real rates, rather than a change in inflation expectations. Indeed, inflation fears, which fuelled the first phase of the sell-off last year, have been benign if not falling in 2022. So, this sell-off is not about inflation, rather the market feeling that central banks have got policy conditions calibrated incorrectly.

Lastly, the flattening of the yield curve might be telling us that we are getting close to a stage where the economic outlook is being compromised by these expectations of future interest rates.

Investment grade credit

It was another volatile week in investment grade with spreads ending the week marginally wider. The market feels weaker as outflows continue to drain on the asset class, on top of returns remaining negative. The earnings season is still powering through with generally good reports overall.

In corporate news, on Friday it came to light that UniCredit could propose a takeover deal to Banco BPM, which sent the Banco BPM stock price up to a four year high. It has since transpired that no such communication was made causing the price gains to stall. Market consensus is that it would make financial and strategic sense for UniCredit to move ahead with the takeover.

High yield credit & leveraged loans

US high yield bond prices came under pressure over the past week and spreads were modestly wider as markets continue to pull forward an aggressive pace of Fed interest rate hikes in response to inflationary pressures. The ICE BofA US HY CP Constrained Index returned -0.88% and spreads were 11bps wider. The asset class saw another $1.9bn outflow for the week and YTD outflows now total more than $14bn.

Meanwhile, leveraged loan prices declined -$0.10 amid record retail inflows as the product continues to be a beneficiary of the hawkish central bank landscape, and prices have been largely insulated from the elevated equity and rate volatility in 2022. The asset class experienced a record weekly inflow of $2.3bn, according to Lipper, while YTD inflows total $12.4bn.

European high yield experienced a week of widening spreads, and the fifth consecutive week of losses, though more subdued than before. Most of the trading appears to be indiscriminate, pushed by the ETF sales and driven by maturity and liquidity. The primary market had only one €1.4bn deal from Cerved (Italian credit and risk intelligence firm), in two tranches, largely skewed to a floater with a small fixed (€350m). The pipeline looks likely to be quiet until early March as is typical this time of the year.

On the M&A front, Italian telecom Iliad had its €11.25bn bid for Vodafone's Italian business rejected as being too low. In Spain, Vodafone has hired investment bankers to begin serious discussions of a sale to MasMovil. In auto news, Valeo, the French autoparts company, announced it had bought its 50% share in the Valeo Sieman JV (EV motor & parts development) for €277m. Even though this will drag on performance in the short term (as it will increase net debt for Valeo), it will be a big boost to its EV production in the longer term. In more Valeo news, the firm announced it is forming a strategic partnership with Renault for design, co-development and manufacture, in France, of a new generation automotive electric motor that will eliminate the use of rare earth metals. This is an additional signal that the company is moving towards being more ESG focused in its activities.

In credit rating moves, the German real estate firm Adler was downgraded to by S&P to B-, credit watch negative. This is a strong reflection of the concern that the delayed publication of full year results, announced earlier, could breach a reporting covenant.

Structured credit

The US Agency MBS market was down 56bps last week as rates bear-flattened. The 2-year US Treasury experienced the largest one-day sell-off since 2009, while Fed speak of more hikes and possible sale of assets tipped the scales in bond markets. At this point, we have almost seven hikes in the price for 2022 and the 2/10s curve has inverted six months out. Mortgages held in better than expected with mortgage rates now up 80bps. We also had two FOMC governors speak in favour of the Fed actively selling its MBS holdings. We believe outright sells are unlikely in the near term (2022) but would widen spreads if sells do happen in 2023. In CMBS, spreads drifted wider on broad market volatility. Investor interest was primarily in shorter dated, high-quality paper; however, volumes picked up in lower-quality paper as spreads moved more in the money at 75-100bps off the tights. In ABS, new issuance has been robust. January came in at the highest level since 2018. Autos continue to experience higher delinquencies; however, other ABS sectors show ongoing strength in consumer behaviour.

Asian credit

Chinese regulators are getting the large state-owned AMCs (asset management companies) to participate in the debt restructuring of property developers and acquire property projects to relieve the liquidity stress in the China property sector.

The PBOC and CBIRC (China Banking and Insurance Regulatory Commission) have also announced the removal of caps on bank loans to fund public rental housing. The PBOC is effectively encouraging the banking financial institutions to increase the funding support for affordable rental housing.

Cailian (news agency) reported that government has released guidelines to standardise the management of escrow accounts in China. The guidelines clarify the required amount and withdrawal standard based on factors such as construction costs and project progress. The guidelines also specify that once an escrow fund reaches the required amount, the property developer can withdraw the excess funds. The standardisation of the pre-sales funding rules and the scope for potentially better access to the pre-sales funds is positive.

Emerging markets

On Friday, the People's Bank of China quarterly policy report cited pressures from "shrinking demand, supply shocks and weakening expectations". The report also mentioned monetary policy support would be well targeted and front loaded and indicated willingness to see rising debt to GDP levels to stimulate the economy.

In Angola, the IMF programme supporting economic reforms has concluded successfully, and the country is not currently considering requesting a follow-up programme. Key reforms include maintaining a sustainable fiscal policy stance, diversifying the economy away from oil dependency, pursuing governance reforms and creating conditions to attract private sector investment.

In ratings news, Turkey was downgraded by Fitch from BB- to B+ with a negative outlook. The rationale for the downgrade included high inflation, low external liquidity and weak policy credibility. Fitch also downgraded El-Salvador from B- to CCC. The downgrade was driven by an increased reliance on short-term debt and an unfunded, upcoming principal payment with little scope to borrow further.

Commodities

The biggest mover on the week was US natural gas with a 13.3% decline. Prices have been reversing following a substantial rally at the end of January, driven by a cold snap in the US.

Brent edged above $95 on the back of Russian/Ukrainian tensions after a US security advisor flagged a risk that Russia could seek to invade Ukraine this week. Russia is a key global exporter of many major commodities, most notably supplying 45% of the world's palladium, a key input for the auto industry. Russia and Ukraine are also two of the largest exporters of wheat.
Agricultural commodities continued their rally with a 2.6% gain. Worsening weather in South America has been enhanced pressure on the northern hemisphere where agricultural growth has been hampered by machinery shortages and rising fertiliser prices.

Responsible investments

It's almost been three months since the COP26 summit, and we're now really starting to see those nations who are keeping to their promises. Last week the earth's third largest energy consumer, India, has set a target to remove the use of diesel in its farming industry by 2024. The nation are top growers of sugar, cotton and grains and will aim to replace diesel usage with renewable fuels to meet its target. In turn, not only will it help towards net-zero goals, but also reduce the dependency on the import of diesel from other parts of the world.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

14th February 2022

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	▪ 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) P ¥ $ Short -2 -1 0 +1 +2 Long £ €	▪ 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	▪ 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) ¥ EM A$ Short -2 -1 0 +1 +2 Long £ $ E	▪ The potential for an end to negative rates in the eurozone is significant for the Euro given non-linearities around the zero bound ▪ Experience of past cycles suggests the Dollar fares less well at the start of a cycle, turn neutral USD for now	▪ ECB concludes no risk of second round inflation effects and leaves policy on hold ▪ BoE meets lofty market expectations for hikes
Emerging Markets Local (rates (R) and currency (C)) R Under-weight -2 -1 0 +1 +2 Over-weight 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

Important information: For use by Professional and/or Qualified Investors only (not to be used with or passed on to retail clients). Source for all data and information is Bloomberg as at 14.02.2022, unless otherwise stated.

This material in this publication is for information only and does not constitute an offer or solicitation of an order to buy or sell any securities or other financial instruments to anyone in any jurisdiction in which such offer is not authorised, or to provide investment advice or services. Offerings may be made only on the basis of the information disclosed in the relevant offering documents and the terms and conditions under the relevant application forms. Investment involves risk. You are advised to exercise caution in relation to this material. Please refer to the relevant offering documents for details and the risk factors. Past performance is not a guide to future performance. The value of investments and any income is not guaranteed and can go down as well as up and may be affected by exchange rate fluctuations. This means that an investor may not get back the amount invested. The analysis included in this publication has been produced by Columbia Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice and should not be seen as investment advice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed. The mention of any specific shares or bonds should not be taken as a recommendation to deal. This document includes forward looking statements, including projections of future economic and financial conditions. None of Columbia Threadneedle Investments, its directors, officers or employees make any representation, warranty, guarantee, or other assurance that any of these forward looking statements will prove to be accurate. This document may not be reproduced in any form or passed on to any third party in whole or in parts without the express written permission of Columbia Threadneedle Investments. This document is not investment, legal, tax, or accounting advice. Investors should consult with their own professional advisors for advice on any investment, legal, tax, or accounting issues relating an investment with Columbia Threadneedle Investments. This document and its contents have not been reviewed by any regulatory authority.

Issued by Threadneedle Investments Singapore (Pte.) Limited ["TIS"], ARBN 600 027 414. TIS is exempt from the requirement to hold an Australian financial services licence under the Corporations Act and relies on Class Order 03/1102 in marketing and providing financial services to Australian wholesale clients as defined in Section 761G of the Corporations Act 2001. TIS is regulated in Singapore (Registration number: 201101559W) by the Monetary Authority of Singapore under the Securities and Futures Act (Chapter 289), which differ from Australian laws. Issue by Threadneedle Investments Singapore (Pte.) Limited, Winsland House 1, Singapore 239519, which is regulated in Singapore by the Monetary Authority of Singapore under the Securities and Futures Act (Chapter 289). Registration number: 201101559W. This advertisement has not been reviewed by the Monetary Authority of Singapore. Issued by Threadneedle Portfolio Services Hong Kong Limited 天利投資管理香港有限公司. Unit 3004, Two Exchange Square, 8 Connaught Place, Hong Kong, which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 regulated activities (CE:AQA779). Registered in Hong Kong under the Companies Ordinance (Chapter 622), No. 1173058. Issued by Threadneedle Asset Management Limited (TAML). Registered in England and Wales, Registered No. 573204, Cannon Place, 78 Cannon Street, London EC4N 6AG, United Kingdom. Authorised and regulated in the UK by the Financial Conduct Authority. In Japan: Issued by Columbia Threadneedle Investments Japan Co., Ltd. Financial Instruments Business Operator, The Director-General of Kanto Local Finance Bureau (FIBO) No.3281, and a member of Japan Investment Advisers Association. This document is distributed by Columbia Threadneedle Investments (ME) Limited, which is regulated by the Dubai Financial Services Authority (DFSA). For Distributors: This document is intended to provide distributors with information about Group products and services and is not for further distribution. For Institutional Clients: The information in this document is not intended as financial advice and is only intended for persons with appropriate investment knowledge and who meet the regulatory criteria to be classified as a Professional Client or Marketing Counterparties and no other Person should act upon it.

Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies. columbiathreadneedle.com