COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

4 APRIL 2022

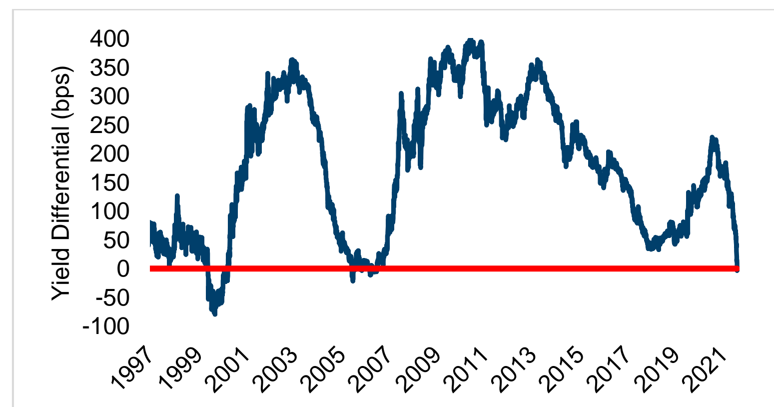
The only way is up

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	2.40%	-7 bps	-3.0%	-5.6%
German Bund 10 year	0.51%	-8 bps	-2.9%	-5.1%
UK Gilt 10 year	1.55%	-15 bps	-2.2%	-7.5%
Japan 10 year	0.21%	-2 bps	-0.3%	-1.6%
Global Investment Grade	124 bps	-10 bps	-2.3%	-6.9%
Euro Investment Grade	129 bps	-13 bps	-1.4%	-5.3%
US Investment Grade	120 bps	-9 bps	-2.6%	-7.7%
UK Investment Grade	119 bps	-8 bps	-1.2%	-6.2%
Asia Investment Grade	206 bps	-15 bps	-2.2%	-5.3%
Euro High Yield	408 bps	-21 bps	-0.1%	-4.7%
US High Yield	340 bps	-11 bps	-0.9%	-4.5%
Asia High Yield	725 bps	-191 bps	-2.5%	-10.8%
EM Sovereign	348 bps	-43 bps	-1.1%	-9.3%
EM Local	6.3%	-8 bps	-1.5%	-6.5%
EM Corporate	326 bps	-56 bps	-2.5%	-8.8%
Bloomberg Barclays US Munis	2.6%	3 bps	-3.2%	-6.2%
Taxable Munis	3.6%	-3 bps	-5.4%	-9.6%
Bloomberg Barclays US MBS	24 bps	-8 bps	-2.6%	-5.0%
Bloomberg Commodity Index	267.80	-4.6%	8.6%	25.5%
EUR	1.0992	0.5%	-1.4%	-2.7%
JPY	122.70	-0.4%	-5.5%	-5.4%
GBP	1.3115	-0.5%	-2.1%	-2.9%

Source: Bloomberg, Merrill Lynch, as at 4 April 2022.

Chart of the week: US 30-year treasury yield vs. 2-year yield



Source: Columbia Threadneedle Investments, as at 4 April 2022.

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Macro / government bonds

Yields headed ever higher last week. The most recent sell-off has been driven by both higher real yields and rising inflation expectations. 10-year inflation expectations are the highest since the introduction of inflation-protected bonds in 1996. Real yields are rising but are still in negative territory and much lower than long-term averages. The US yield curve is now trading flat with the 2-year yield exceeding the 30-year yield for the first time since 2007, a harbinger of recession **(see chart of the week).**

The UK followed other nations in reporting a historically high rate of inflation. Consumer prices rose by 6.2% y/y in February, which is a 30-year high for this particular barometer. Although core price rises (ex food and energy) increased at a lower rate of 5.2%, the CPI rate is expected to peak around 8.5% in April after the energy regulator allows a substantial rise in bills. Consumers are facing the impact of higher fuel and heating bills, rising mortgage rates and a sharp increase in food prices.

In response, the government increased the threshold at which Britons start paying National Insurance, pledged to cut the basic rate of income tax by 1% in 2024, cut fuel duty by 5% until 2023 and scrapped the sales tax on domestic energy efficiency measures.

Investment grade credit

A modest rebound in credit spreads continues. Global investment grade spreads have widened from less than a 100bps over government bonds to over 150bps in the space of two and a half months. In the last two weeks of this quarter spreads are tighter and are now below 140bps.

A similar picture is seen in sterling and European investment grade with spreads ending the month of March at 119bps and 129bps respectively. Both markets have tightened over the last few weeks but are still wider YTD.

The investment grade market is down on issuance by 6.3% vs this time last year, although deals are consistently oversubscribed. At the better end, recent new issuance from Deutsche Bank came in 7.6x oversubscribed, whilst at the 'worst' end a deal from Nestle came in at 1.9x oversubscribed.

High yield credit & leveraged loans

U.S. high-yield bond yields declined 12bps over the past week and spreads ended the week (+359bps) 69bps inside March's wide amid receding withdrawals, light capital market activity, and limited spill over to growth sentiment from a hawkish Fed backdrop and geopolitical tensions. The ICE BofA US HY CP Constrained Index returned 0.73% over the week and spreads were 12bps tighter. According to Lipper, the asset class reported a $1.2bn inflow over the week, marking the first weekly inflow since early January. YTD outflows total $25bn. The US High Yield index declined 0.91% in March and has returned -4.51% YTD.

Meanwhile, the average price of the J.P. Morgan Leveraged Loan index increased $0.43 over the past week and have recouped $1.60 of the $2.90 decline between late-January and mid-March. Loans continue to benefit from the hawkish Fed backdrop and recalibration of rate expectations. The asset class also benefited from lighter issuance, a reacceleration of retail inflows, and an improvement in CLO activity. Loan funds reported a $1.2bn inflow for the week leaving the YTD total inflow at $18.7bn. The index returned 0.12% in March and -0.01% YTD.

European High Yield (EHY) finished March with a small negative performance due to the rise in underlying government bond yields as EHY spreads tightened more than 40bps over the month. This meant that for the first time, in more than 10 years, the asset class experienced three consecutive months of negative performance (the last time was Q2, 2011). Single Bs were the strong outperformer for March while CCCs outperformed last week. The primary market remained subdued with just two deals (Co-op Bank and Cellnex). Market talk is that the primary market won't really pick up until after Easter. Fund flows were light with a small outflow from the asset class via both ETFs and managed accounts (-€138m). Market liquidity though somewhat improved and more balanced remains relatively poor compared to normal market conditions.

In issuer specific news, the Telecom Italia (TI) story continues with KKR now threatening to walk away from its TI bid if they are not allowed to do a due diligence. This came as the private equity group reiterated its interest in TI. This was reported at the same time that TI confirmed it has signed an NDA with CDP to start preliminary discussions on a potential merger with Open Fiber, an Italian telecom company. In another case of drawn-out discussions, Atlantia, the Italian infrastructure business, announced that all the conditions precedent for the sale of Autostrade have now been met (and ahead of the 'long stop' date of 31 March 2022). Closure of the transaction is expected by the end of April.

Structured credit

The US Agency MBS market rallied last week on improved interest rates. The sector was up 59bps alongside other duration sensitive asset classes. This week we will get more information on the Fed's balance sheet plans this week. At this point, the market is priced for and expecting balance sheet runoff including treasuries and MBS and no outright selling of either. Mortgage rates are now appreciably higher with current production coupons 150bps greater versus the start of the year. Refinancing volumes, however, remain elevated with cash-out refis at all-time highs. Average loan size has also been rising, which is no surprise given home price appreciation in the US, lack of supply and the related bidding environment. In CMBS last week, high-quality bonds tightened on yield buying while mezzanine bonds widened on new conduit supply.

Asian fixed income

As March came to a close, several China property developers were unable to release either their audited or unaudited FY21 results. There are several reasons for the delay in FY results reporting. Several property developers communicated that they have changed their auditors while others stated that more time is required to complete the audit work. For some companies that reported their audited FY21 results before 31 March 2022, their financial statements however were prepared with going concern qualification. Among others, these companies included Redsun, Times China, Yuzhou, Zhenro Properties, Beijing Properties and Zhongliang Holdings.

Companies which announced a change in auditors this year, include Shimao Group, Powerlong Real Estate, Ronshine, Yuzhou, Hopson and China Aoyuan. Among these companies, Powerlong and Ronshine have issued their unaudited FY results while Yuzhou and Hopson published their audited results. On another hand, China Aoyuan and Shimao Group were unable to release even their unaudited results. The inability to publish the FY21 results was also pervasive among companies that retain their existing auditors.

Sunac which did not release its unaudited results, cited that more time is required for the uncompleted parts of the preparation of its financial statements as well as issues with its offshore loans that emerged following its credit ratings downgrade. Another reason was the proposed extension of its onshore CNY4bn. That said, on 1 April, Sunac China received the approval from onshore bondholders of this CNY4bn bond for an 18-month extension. Around 82.3% of bondholders voted in favour of this revised extension proposal compared with Sunac's original proposal for a 2-year extension. The principal payment will be paid in instalments every few months and the Chairman Sun Hongbin provides unlimited guarantees as a credit enhancement.

On a positive note, Country Garden has obtained a CNY40bn of credit line from Agricultural Bank of China, which comprises CNY20bn for property M&A and rental housing, and CNY20bn for mortgage loans. CIFI also received a CNY10bn credit line for M&A from the Bank of Communications. It also issued CNY1.95bn of 3-year convertible bonds with a coupon of 6.95%. With regards to the preliminary contracted sales number in March 2022, China Real Estate Information Corp data show a decline of 52.7% y/y for the 100 largest property developers.

China Securities Regulatory Commission, the Ministry of Finance and other regulators have jointly issued the proposal for the revision of rules related to overseas listing, which is a positive step towards lower the risk of delisting for Chinese companies on the US stock exchanges.
The government agencies acknowledge that the original provisions (released in 2009) to regulate the confidentiality and archives administration in the overseas listing, have fallen short in certain aspects, for example in cross-border audit and regulatory collaboration. The revisions, include among others, the introduction of clear guidance to define companies' confidentiality responsibilities, removing the stipulation that on-site inspections shall be dominated by domestic regulators or dependent on their inspection. The proposed revisions also include the stipulation that overseas securities regulator may request to inspect under a cross-border regulatory cooperation mechanism.

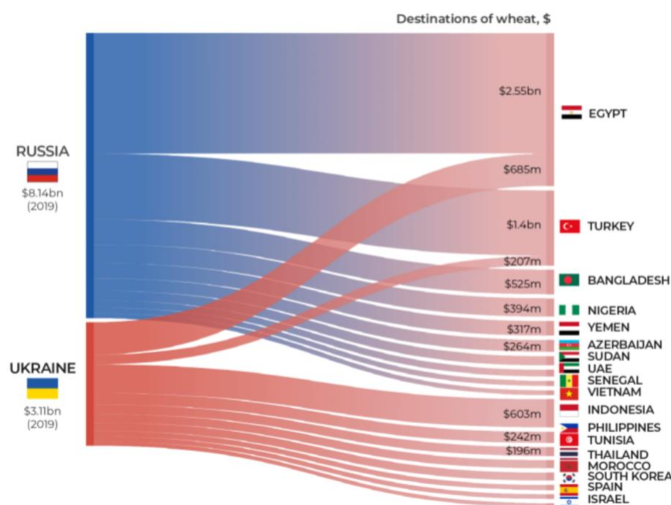
That said, China will accept that those companies holding sensitive data could face delisting. The SEC continues to state that companies that intend to remain listed must be wholly compliant with audit inspections.

Emerging markets

To block an impending no confidence vote Pakistan's president Imran Khan triggered an election. Pakistan has Asia's second highest inflation at 12.2%, surging food and energy prices have put Khan under pressure, especially from his upper middle class support base. Khan recently announced a cut in energy prices to soothe household pressure; however, this has come under scrutiny from the IMF, who Pakistan has been engaging with following the 2019 $6bn rescue package. Qatar has announced a $5bn investment in Egypt. This follows announced investments of $3bn by UAE and $15bn from Saudi Arabia. Some of this money is going towards food subsidies. Egypt is currently suffering higher inflation due to the supply disruption form Russia/Ukraine conflict as Egypt imports the vast majority most of its wheat from Russia and Ukraine **(see chart on next page).** The funding well also help alleviate short-term funding pressures.

In central bank news Chile (+150bps), Columbia (+100bps), Dominican Republic (+50bps) and Czech Republic (+50bps) all delivered interest rate hikes. Thailand held rates at 0.5%.

Russia and Ukraine wheat export destinations 2019



Source: Al Jazeera as at 17 February 2022.

Commodities

The commodity index sold off last week led by a 9.5% decline in brent and an 8.7% sell-off in heating oil. The decline was driven by a combination of the demand shock of Shanghai going into lockdown and the announcement of the US Strategic Petroleum Reserve (SPR) release. Specifically, the US will release 180bn barrels of crude over the course of six months, this equates to approximately 1% of global oil demand. US president Biden also expects allies from the International Energy Association (IEA) to release an additional 30-50m barrels.

Metals also declined on the week driven by Shanghai's outsized role as an import and storage hub. Nickel sold off 6.4% and Aluminium by 4.5%. Tesla operates its only non-US "Gigafactory" in Shanghai.

Russia's invasion of Ukraine has also disrupted the supply of almost half of the world's sunflower oil, prices are now up 1000%. The surge has resulted in UK retailer Iceland to shift to alternatives such as rapeseed oil and environmental pariah, palm oil.

Responsible investments

Figures out of the UK and Europe last week showed greenhouse gas emissions for 2021 rebounding and higher than those of 2020. This is clearly due to the reopening of numerous industries post-covid lockdowns, as well as a pick-up in travel, but difficult to digest when both nations have tight deadlines to meet to be net zero on carbon emissions in the coming decades. In the UK, despite a 4.7% rise against 2020, it was still lower overall in 2021 than pre-Covid 2019 levels. It's likely that this was helped by the power station closures we've seen across the country over the last year. It's a slightly different tone in Europe as we look to the remainder of this year; the dependency on alternative fuel supply on the back of the invasion of the Ukraine from Russia has meant some power stations have been burning more coal as the price of natural gas surges. This will, of course, not help overall emissions figures and puts more pressure on EU officials who are currently processing the passing of legislation that aims to have cut emissions by 55% by 2030.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

04th April 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 (■: 0)	▪ Credit spreads have widened during recent volatility, which has been paired with neutral to worsening technicals and stable fundamentals in most sectors. This has created more pockets of opportunity, along with the deleveraging & upgrade stories. ▪ We are past the peak of economic growth, with first hike announced at the March FOMC meeting and expectations for many more. Pullback in forecasted liquidity created opportunity for market volatility. ▪ Uncertainty remains elevated due to fears surrounding pace of central bank hiking, inflation, recession probabilities, and the Russian invasion of Ukraine.	▪ Upside risks: lowered volatility once expansionary environment is established as the new normal ▪ Downside risks: more spillover from Russian invasion, sanctions difficult to remove post-conflict. More Covid variants emerge. Supply chain disruptions and inflation persist to H2 2022. Simultaneous low unemployment, hiking and slowing growth could cause a recession. Persisting commodity shocks
Duration (10-year) ('P' = Periphery)	Short -2 -1 0 +1 +2 Long (¥: 0; P, $: +1 above; £, €: +1 below)	▪ Carry offered by front end yields now attractive ▪ Longer yields continue to be capped by long-run structural downtrends in real yields ▪ Inflation likely to normalize over medium term ▪ Hiking cycles to be shortened by easing inflation and moderating demand	▪ Inflationary dynamics become structurally persistent ▪ Labour supply shortage persists; wage pressure becomes broad and sustained ▪ Fiscal expansion requires wider term premium ▪ Long run trend in safe asset demand reverses
Currency ('E' = European Economic Area)	Short -2 -1 0 +1 +2 Long (¥, EM, A$ above 0; $, £, E below 0)	▪ The invasion of Ukraine will hit global growth, hinder risk markets and lend a bid to the Dollar ▪ The associated impact of higher inflation on central banks is uncertain, but is more likely to see a dovish repricing of the ECB than the Fed, we turn neutral on the Euro	▪ The ECB becomes concerned around potential second round effects and presses on with policy normalisation
Emerging Markets Local (rates (R) and currency (C))	Under-weight -2 -1 0 +1 +2 Over-weight (R: 0; C: 0)	▪ Russia/Ukraine conflict cautions against aggressive positioning ▪ Aggressive Fed pricing may now open the door to selective EMFX performance ▪ EM real interest rates relatively attractive, curves steep in places	▪ Negative sentiment shock to EM fund flows ▪ 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 (■: 0)	▪ Valuations are getting more attractive, although for reason ▪ Russian invasion is primary story, as pressure from commodity price shocks, retail fund outflows, spread widening spillover and general uncertainty is felt across EM. ▪ Market-wide shock has created opportunities as some widening cannot be justified by fundamentals (esp. energy) ▪ DM tightening financial conditions will unevenly impact EM credit and EMFX as many countries have already responded to inflation through hikes	▪ Continued spillover from Russian invasion: local inflation (esp. food & commodity), slowing growth ▪ A replay of 2013 occurs with a taper tantrum or swift appreciation of the USD ▪ Persisting COVID growth scars hurt economies & fiscal deficits ▪ Weakening technicals with large fund outflows and slower supply
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight (■: 0)	▪ US and EMEA spreads have crept significantly wider, creating buying opportunities for favored sectors ▪ Robust new issue supply is seeing large concessions, despite absence of credit quality concerns ▪ IG has been historically resilient in the face of inflation, which has been broadly supported by earnings. ▪ Good fundamentals with strong balance sheet management, M&A and deleveraging from capital management & sales growth	▪ Iinvestors return to government bonds from IG as their risk/return preference for safe assets is changing in new environment ▪ Russian Invasion worsens operating environment globally ▪ 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 (■: 0)	▪ Spreads have widened relative to 2021, creating buying opportunities for high conviction/quality and rising star trades. Expect volatility to continue. ▪ Risks for EMEA HY are heightened because of proximity to and economic impact of Russian invasion ▪ Bank loans are still attractive despite recent market softening as we expect tailwinds will pick back up: positive retail fund flows, strong issue calendar, demand from CLO formation. ▪ Defaults are set to continue near historic lows	▪ Waves of ratings upgrade continue into this year. ▪ Russian invasion significantly rattles US bond loan/market as already seen in EMEA from commodities.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight (■: -1)	▪ The risk/reward mix in MBS Basis approaching fair value. ▪ Specified Pools and CMOs have cheapened into market sell-off with fair fundamentals: buy opportunities. ▪ Valuations have widened since November, recently stabilizing in wider range like 2018-2019 levels. Elevated 2022 supply projections remain a headwind.	▪ Housing activity slows and rising rates move prepays to normal levels without hurting mortgage servicing rates. ▪ Uncertainty with the Fed hiking schedule and long-term position within the Fed balance sheet
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight (■: +1)	▪ Our preference remains for Non-Agency RMBS and CLOs as spread widen and liquidity worsens ▪ RMBS: Housing continues to perform well but expect normalization coming from heavy supply and extension concerns. Selectively adding to positions at wider spreads. ▪ CMBS: Most segments maintain strong but new issue marker is slowing into spread weakness. ▪ CLOs: Spreads wider across cap structure, but sector is still reval attractive. New issue deals are slowing as investors look for discounts in the secondary market ▪ ABS: US consumer remains well positioned, although headwinds mounting. Select opportunities in de-levered structures in consumer loans or subprime auto	▪ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening ▪ Changes in consumer behavior in travel and retail fail to return. ▪ Work From Home continues full steam-ahead post-pandemic (positive for RMBS, negative for CMBS). ▪ SOFR deals 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 (■: 0)	▪ o/w Copper & Lead vs Zinc ▪ u/w Livestock ▪ u/w Gold ▪ o/w Oil	▪ Global Recession

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