COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

17 MAY 2021

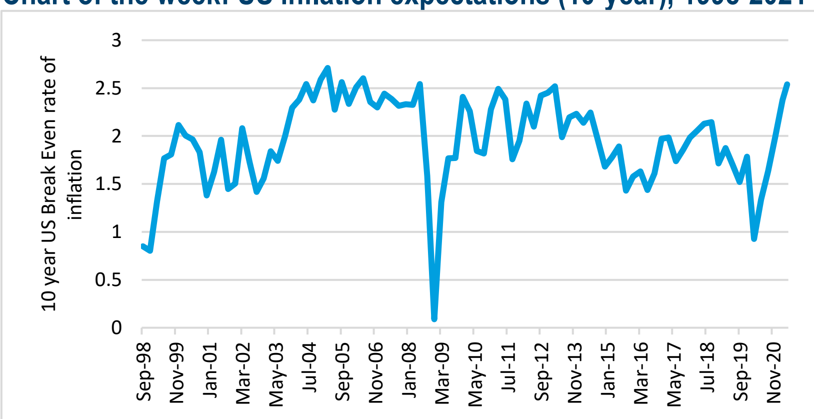
Breaking Bad.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.64%	6 bps	-0.1%	-3.9%
German Bund 10 year	-0.11%	11 bps	-0.6%	-3.7%
UK Gilt 10 year	0.88%	10 bps	-0.7%	-7.6%
Japan 10 year	0.09%	0 bps	0.1%	-0.2%
Global Investment Grade	94 bps	0 bps	0.2%	-2.7%
Euro Investment Grade	85 bps	0 bps	-0.4%	-1.1%
US Investment Grade	92 bps	-1 bps	0.0%	-3.4%
UK Investment Grade	93 bps	0 bps	-0.4%	-3.9%
Asia Investment Grade	212 bps	5 bps	0.1%	-1.6%
Euro High Yield	316 bps	2 bps	0.7%	1.6%
US High Yield	335 bps	8 bps	0.0%	2.0%
Asia High Yield	554 bps	8 bps	0.3%	1.5%
EM Sovereign	308 bps	-2 bps	0.4%	-2.5%
EM Local	5.0%	6 bps	1.5%	-3.1%
EM Corporate	296 bps	-1 bps	0.3%	0.1%
Bloomberg Barclays US Munis	1.1%	4 bps	0.0%	0.5%
Taxable Munis	2.4%	4 bps	-0.2%	-2.7%
Bloomberg Barclays US MBS	13 bps	3 bps	-0.3%	-0.8%
Bloomberg Commodity Index	198.00	-1.9%	1.8%	17.9%
EUR	1.2145	-0.2%	1.0%	-0.6%
JPY	109.20	-0.7%	0.0%	-5.5%
GBP	1.4107	0.8%	2.0%	3.1%

Source: Bloomberg, Merrill Lynch, as at 14 May 2021.

Chart of the week: US inflation expectations (10-year), 1998-2021



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

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Macro / government bonds

The key theme this year for markets has been the trend higher in inflation expectations and the question of whether the US economy is overheating. This has prompted a rise in government bond yields, with German and UK yields reaching the highest yield point since Spring 2019 last week.

Chart of the week plots inflation expectations in the US and how these have evolved since the (exceptional) lows of last year. Why does this matter? The continued market-supportive cradle of ultra-easy monetary conditions rests on the presumption that inflation (which is targeted by most central banks) remains low and below / around target. With this in mind, last week's US Consumer Price Inflation report made for difficult reading. Prices rose by 4.2% y/y, which is the highest rate of this measure of inflation since 2008 and much higher than was expected. Adjusted for volatile food and energy prices (the core rate), inflation is running at 3.0%; so lower but still the highest this measure has come in at since 1996. The surge in inflation was heavily influenced by the transportation sector (including used car and truck prices). On Friday, the University of Michigan report suggested that consumer sector inflation expectations were the highest in 10 years at 3.1%.

So while a rise in inflation seems to be priced into market and consumer expectations the response by senior policymakers at the US Federal Reserve (and European Central Bank) has been to downplay these fears and suggest that rising inflation is transitory in nature rather than a secular change in the low inflation conditions that have characterised the last years.

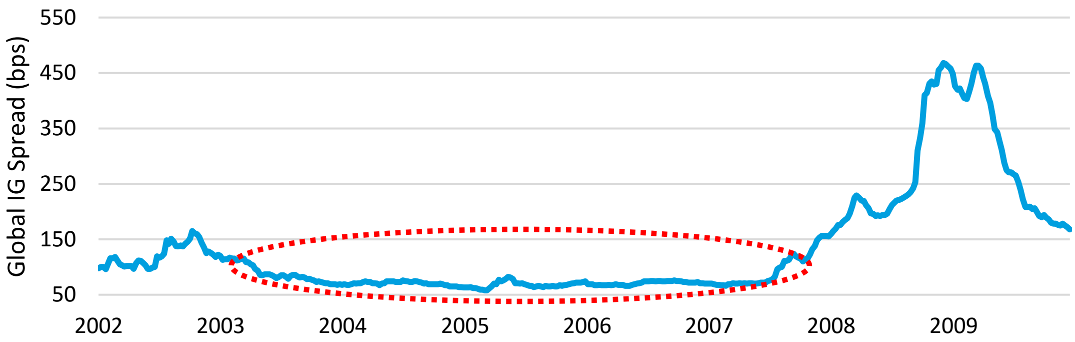
In Europe, rates have been rising more quickly than in the US in the last few weeks with Italy an underperformer and serial issuer of debt. Spreads for Italian bonds are now nearly 10% wider than at the start of the year after the post-election period of outperformance.

Investment grade credit

If the key theme for government markets has been rising inflation expecations so one of the themes for credit markets has been a lack of spread volatility. The credit default swap index (Main) in Europe as an example has been in a 10-basis point range for the last six months. Cash bonds have performed better and are around 9% tighter this year but have barely moved a basis point in the last few weeks.

Should this concern us? Recalling the period from around 2003-2006 (**see second chart of the week)**, market spreads were tight (more so than now) and remained so for a few years. At the time, investors looked backwards and assumed these benign conditions would continue into the future. This helped fuel lower risk aversion / greater risk taking – at exactly the wrong time. The Global Financial Crisis was, of course, only a few quarters away. Periods of low but rising volatility have been difficult to digest for credit markets. Today we have the 'low' and last week the VIX measure popped a little higher (temporarily). Not a trend… but worth watching.

Second chart of the week: Global Investment grade spreads (2002-2009)



Source: ICE BofA Indices, Bloomberg, Columbia Threadneedle Investments, as at 17 May 2021.

High yield credit

The euro high yield market saw spreads widened 2bps last week, with single B outperforming both BBs and CCCs as new issuance remained the main focus. European high yield experienced a small outflow (€77m), entirely due to ETFs. Similar to the previous week, market softness was likely due to the heavy primary market as nine new bonds were issued for a total of about €4bn. Issuance is at 140% compared to 2020, with issuers taking advantage of the strong market to finance at attractive levels. The primary market is also being fuelled by the LBOs seen in Q4,20 and Q1,21. Though new issues were generally reasonably well received, investors are showing a greater selectivity as several of them are already trading below their issuance price. Results continue to be fairly decent with companies delivering on cost cutting targets. There is talk of price increases given tight supply chains, likely to come through in Q2 or Q3 for most other companies. This week saw more rating upgrades (Loxam and Goodyear Tyre) reflecting strong performance in 2020, cost cutting efforts, strong cash flow performance and resilient margins. There was also IPO news with Autodis, the world's largest car seat manufacturer, registered to IPO; this could be net positive for the issuer if an equity IPO is used as a deleveraging.

Asian credit

The Asian commodity producers reported strong quarterly results. Geo Energy, the Indonesia coal miner, delivered a strong Q1,21 quarter, with Q1 revenue rising 31.6% q/q to $114.5m (+30.4% y/y), marking the highest revenue posted in a single quarter. Q1 EBITDA also rose sharply to $42.7m (+91.4% q/q, +270% y/y). The strong Q1 was driven by the increase in average coal selling price (+39.5% q/q to $38.85/tonne), helped by China's continued curtailment of Australia coal import, which boosted the demand for Indonesia coal. For the 2021, Indonesia's Ministry of Energy and Mineral Resources (MEMR) has increased the 2021 national coal production target by 75m tonnes to 625m tonnes on expectations of continued strong demand.

Vedanta Resources also posted strong Q4 FY21 results (FY ended 31 March 2021). The Q4 EBITDA rose 88% y/y to INR91bn (+18% q/q), thanks to higher volume in and better commodity prices at its aluminium segment, Hindustan Zinc and iron ore segments. Studio City Finance has also raised additional funding for the Studio City Phase II project by completing a $350m tap on the existing STCITY 5% '29s bond.

Structured credit

On a backdrop of higher rates, the US Agency MBS market sold off by 29bps on the week, pushing year-to-date returns down to -84bps. In contrast, CMBS cash spreads hung in and ended the week a bit tighter. New AAA bonds cleared the market at +68 while BBB- cleared at +295, marking a 900bps improvement from March 2020. Investor interest has been strong of late as witnessed through higher secondary volumes, while delinquencies have slowed markedly with newly delinquent loans at less than half the volume reported last month ($308m vs $866m last month). In ABS, new issuance remains robust, albeit slowing from 2020 levels. Despite elevated supply, spreads have been more or less unchanged. According to the most recent data from the NY Fed, aggregate household debt continued to climb in Q1,21, up 1% q/q and 2% y/y, led by an increase in mortgage debt while credit card debt continued to contract. Meanwhile, consumer performance has improved significantly, with delinquencies down across a number of products including prime and subprime auto.

Emerging markets

In EMD, strong Local currency bonds flows continued with a $1.2bn inflow, with hard currency flows flat at $86m. In central bank news, Chile, Peru, and Mexico all held rates. Mexico noted upside risk in inflation as higher growth outlooks, rising commodity prices and supply bottlenecks continue. In China, data disappointed, particularly regarding retail sales, which delivered a significant miss at 17.7% y/y, compared to a 25% expectation. In corporate news, distressed asset manager Huarong has secured funding agreements from state owned banks allowing it to repay debt to the end of August. This comes following bankruptcy concerns and previously reported disapproval from the state regarding the business' restructuring plan.

In Chile the incumbent right-wing coalition received fewer than a third of the seats in the constitutional assembly, making it harder to block changes from independent and left-wing parties. The result may serve as a harbinger for things to come given the popularity of other left-wing candidates in South America, notably Castillo in Peru.

Commodities

The commodity rally cooled last week with a 1.9% decline; flows into the market remain strong as investors use the asset class as an inflation hedge. The biggest contributor to the decline was agriculture, with corn and wheat down 12.1% and 10.7% respectively. The decline was driven by higher supply projections and lower expected exports from the WASDE report. This comes after the rapid pace of planting within the US in recent weeks. The exception was soybean oil (+4.8%), which has rallied on the back of the vegetable oil shortage.

Energy markets rallied marginally (+0.6%) as the Colonial Pipeline resumed operations. However, there are reports that $5m in ransomware was paid. In base metals, aluminium (-3.2%) and copper (-2.0%) gave back some of their recent gains. Prices fell on the back of fears of softer demand from China and Covid-19 concerns as both Taiwan and Singapore tightened pandemic restrictions.

Responsible investments

Last week, Elon Musk managed to send Bitcoin into quite a sell off after he announced Tesla would no longer be accepting the cryptocurrency as a valid form of payment for its vehicles. It was only back in the beginning of this year that Musk was able to send Bitcoin into a rally, along with his own company's share price, when he said it would be accepting Bitcoin as a form of payment. This U-turn is off the back of rising concern around the environmental impact mining for the currency has, with research now showing that the electricity consumption for Bitcoin is now 66 times higher than it was in 2016 (according to a recent report by Citigroup). Telsa didn't sell any of its Bitcoin but did touch on its preference for other cryptocurrencies that have a much better carbon footprint.

A port in Bristol, southwest of England, is soon to host the biggest petrol station in the UK. It will supply petrol made from waste (biomethane) to up to 18 heavy goods lorries an hour from 14 high-speed pumps. The company behind the construction, CNG Fuels Ltd., hopes the increase in supply of the 'greener' fuel will help towards the goal of reducing carbon emissions across the UK. Currently, 4% of the country's carbon emissions comes from the heavy goods haulage industry and a move to using biomethane could reduce that figure by 90%.

Japan is on a slow climb to increasing the amount of debt raised by bonds linked to social, environmental and governance purposes. Year-to-date issuance is up 8.2% compared to last year's offerings, a steady climb but far less impressive than the 23% increase we've seen across Europe so far this year. A recent example from that area being Germany's new green bond sale that was 6.48x covered last week.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

17th May 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 with better liquidity than before 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, & central bank reaction functions do increase uncertainty.	■ 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 and Russia or China
Duration (10-year) ('P' = Periphery)	Short -2 -1 0 (¥) +1 (P, $, £, €) +2 Long	■ Valuations suggest lower yields likely ■ Pandemic scarring keeps reflation credibility low ■ Fed QE and high personal savings underpin demand for treasuries ■ ECB likely to lean against rising financing rates ■ Duration remains best hedge for further risk asset correction	■ Permanent fiscal policy shift rebuilds reflationary credibility and raises r* ■ Fiscal largesse steepens curves on issuance expectations ■ Consumption rebound stimulates long-term inflation expectations ■ Risk hedge properties deteriorate
Currency ('E' = European Economic Area)	Short -2 (E) -1 (¥) 0 (£, EM, A$) +1 +2 ($) Long	■ 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 ■ US fiscal push fades
Emerging Markets Local (rates (R) and currency (C))	Under-weight -2 -1 0 (C) +1 (R) +2 Over-weight	■ 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, leading to higher EM inflation via fx ■ 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	■ 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: favoured bonds are still 'story' bonds. A return to normal won't look 'normal' for sectors like office space or convention hotels ■ 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 vs Aluminium ■ o/w Lead vs Zinc ■ o/w Soybeans ■ u/w Livestock ■ u/w Gold	■ US China trade war