COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

20 SEPTEMBER 2021

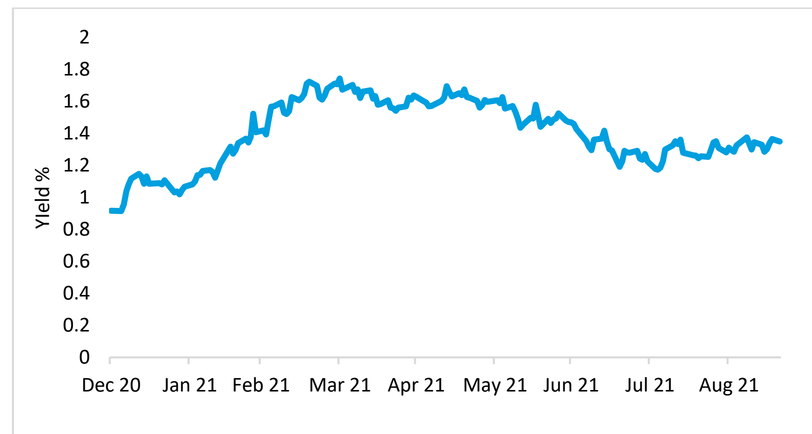
On the road to nowhere.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.33%	-1 bps	-0.1%	-1.7%
German Bund 10 year	-0.31%	2 bps	-0.9%	-2.3%
UK Gilt 10 year	0.81%	6 bps	-1.2%	-5.1%
Japan 10 year	0.05%	1 bps	-0.2%	0.1%
Global Investment Grade	90 bps	-1 bps	-0.1%	0.0%
Euro Investment Grade	83 bps	-2 bps	-0.3%	0.0%
US Investment Grade	90 bps	-1 bps	0.1%	0.0%
UK Investment Grade	86 bps	-2 bps	-0.6%	-1.9%
Asia Investment Grade	197 bps	-1 bps	-0.1%	0.8%
Euro High Yield	295 bps	-10 bps	0.4%	4.2%
US High Yield	304 bps	-7 bps	0.5%	5.1%
Asia High Yield	735 bps	54 bps	-3.5%	-5.1%
EM Sovereign	312 bps	1 bps	0.0%	0.5%
EM Local	5.1%	5 bps	-1.7%	-4.7%
EM Corporate	300 bps	0 bps	0.0%	2.2%
Bloomberg Barclays US Munis	1.0%	0 bps	0.0%	1.5%
Taxable Munis	2.1%	1 bps	0.0%	2.4%
Bloomberg Barclays US MBS	32 bps	0 bps	-0.1%	-0.4%
Bloomberg Commodity Index	205.82	0.5%	1.6%	25.0%
EUR	1.1707	-0.8%	-0.7%	-4.0%
JPY	109.69	-0.1%	0.0%	-6.1%
GBP	1.3675	-0.7%	-0.1%	0.5%

Source: Bloomberg, Merrill Lynch, as at 3 September 2021.

Chart of the week: 10-year US government bond yield – YTD



Source: Bloomberg, Columbia Threadneedle Investments, as at 20 September 2021.

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Macro / government bonds

I think a fair summation of core bonds markets at the moment is rather directionless **(see chart of the week**. On the one hand certain economic data supports the idea of higher bond yields but last week's key US consumer price inflation numbers must have disappointed inflation hawks.

Last week, the US retail sales figures exceeded expectations. August data which was expected to show a decline instead produced a strong positive reading; even more so when volatile auto sector numbers are excluded. On the other hand, headline and core CPI data prompted some to suggest the worst of the 'transitory' inflation blip is behind us. Headline inflation rose by a tenth less than expected (0.3%) while core data showed a more material miss at 0.1% (exp 0.3%). In other US data, industrial production missed by 0.1% but was positive and affected by the disruption from hurricane IDA. Meanwhile, the University of Michigan consumer sentiment survey rose to 71.0.

In China, retail sales were much weaker than hoped after Covid-related blocks on activity and travel. Industrial output was also weaker in the country.

For the UK, retail sales were also much weaker than expected and materially negative on the month, suggesting the delta variant has acted as a sharp brake on activity.

This week brings the FOMC, BOJ and UK MPC meetings and the German election at the weekend; polls suggest the Social Democrats are still in the lead.

Investment grade credit

Investment grade markets are even more directionless than government bonds at present and have been for weeks now. Spreads remain unmoved even as the post summer reopening of markets has enlivened the primary market while the market continues to see inflows.

Power prices in Europe and UK are spiking, driven by concerns over low gas storage levels in Europe ahead of winter and tight supply margins in the UK compounded by interconnector damage. This is a direct negative read across to suppliers as passing on high prices to consumers may result in political intervention. Other utilities exposed to the UK retail market will have the supply risk mitigated by wider group activities and their vertically integrated operating profiles. In Europe, generation and trading units of these vertically integrated players could potentially be direct beneficiaries of higher power prices, offset to some extent the negative impact in their retail activities. The risk of political intervention to limit the sector's ability to pass prices onto consumers is now very high.

High yield credit

US high yield valuations tightened for the fourth consecutive week as declining concerns around the Delta variant and Fed tapering met with stable interest rates and lower than expected new issuance. The ICE BofA US HY CP Constrained index returned 0.17% and spreads were 7bps tighter. While still expected to accelerate over coming weeks, Month-to-date new issuance totals only $13.1bn, which compares to consensus expectations of c$50bn entering the month. According to Lipper flows reversed, with the asset class seeing a $500m outflow after three weeks of inflows.

European high yield had a strong week as spreads tightened to 205bps, a new low for the year. Interestingly, single Bs outperformed BBs and CCCs, for the first time in a while. Flows picked up into the asset class with €231m, largely into managed accounts though ETFs also saw some inflows. The primary market continued to pick up pace, this week with five deals amounting to just shy €2bn; a definite improvement though still far from the heavy issuance talked about in the last weeks of August. The new offerings were oversubscribed and priced well in from the initial price talk. The market tone was very firm, overall, with also a strong secondary market as the street started to show signs of becoming a bit short. Single Bs became hard to source.

In M&A news, Grifols announced the acquisition of Biotest (a plasma derived medicine producer) for €1.1bn. The expectation is that it will help them derive more medication from the protein they already can extract. In other news, Thyssen announced a group sale of a stainless-steel mill in Italy with the expectation of realising €600m to €800m.

In sector news, European car sales were down 18% in August (-24% drop in July) on the back of chip shortages, as all the big five auto markets posted double digit declines. That said, it is expected that volume drops should be mitigated by higher prices and higher margin cars, supporting results.

Leveraged loans

Leveraged loan prices continued to climb for the fourth consecutive week with retail inflows and steady CLO demand providing support. Furthermore, the well-telegraphed M&A calendar has been slow to materialize. The average price of the J.P. Morgan Leveraged Loan Index increased $0.12 over the week and yields and spreads (3-year takeout) decreased 1bps and 5bps to 4.74% and a year-to-date low of +418bps, respectively. The asset class saw a $718m inflow.

Structured credit

The Agency MBS market was down 9bps last week on range-bound rates. Mortgages underperformed corporates as the market readied itself for the US Fed meeting this week. Coupons across the stack were weaker. The main focus of the week were announcements from the FHFA expanding affordable housing initiatives. It was a continuation of the ongoing Biden administration's plan to ease credit standards. Specifically, Trump's provisions that limited: 1) caps on investor property loans to 7% and; 2) limits on the amount of high DTI, low FICO and high LTV lending were rolled back. Meanwhile, it was an active week in non-agency residential MBS. Liquidity continues to be very good at tight spreads on strong consumer metrics. CMBS spreads also held in despite some softness in economic data and excess primary supply. There has been some divergence in secondary vs. primary pricing with primary coming out a bit wider. Secondary supply of BBBs has been limited given the relative attractiveness vs. corporate debt. Demand for mezzanine bonds has been the strongest since the pandemic began given the yield opportunity.

Asian credit

Geo Energy will redeem the GERLSP 8% '22s in October at a redemption price of 102% of the principal amount plus accrued and unpaid interest. As of September 2021, the company reported a cash balance of $120m (30 June 2021: $84m), while it expects to save $4.8m in annual financing costs after redeeming the bonds.

The Macau government is conducting a public consultation on the Gaming Law (Law 16/2001) from 15 September to 29 October 2021. The public consultation covers nine areas that comprise, among others; the scope for increased oversight and supervision of the gaming companies by the government; the potential changes to the concession framework; and the shareholding of the companies. The consultation will also focus on the potential for more non-gaming investments and the review of gaming intermediaries.

Emerging Markets

In China, the shares of property developer Evergrande dropped almost 17% due to default risk on its $300bn debt pile. The company had previously sold $6bn in wealth management products to raise cash; however, it is now offering deeply discounted properties to repay this borrowing.

In Argentina, president Alberto Fernandez has replaced his cabinet chief following criticism from Vice President Kirchner in the wake a poor mid-term vote. Specifically, Fernandez's lack of social spending has come under fire.

Commodities

Energy markets had a strong week with natural gas prices rising by 3.5%, driven by high demand and low supply. Surging gas prices in the UK have resulted in energy company Bulb seeking a government bailout as suppliers have been unable to pass on higher wholesale costs to customers. Russian energy company Gazprom is now set to double gas exports to Europe following the completion of Nord Stream 2.

WTI also had a solid week rallying by 3.4% following production shut-downs in the Gulf of Mexico, following recent hurrancanes. However, as of Friday, only 23% of crude production was still offline.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

20th September 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	■ 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 £ €	■ Rangebound government bond market likely, with bias to lower yields ■ 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)	¥ £ EM Short -2 -1 0 +1 +2 Long E A$ $	■ 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))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ Selective opportunities ■ Still-favourable global liquidity conditions ■ 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
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 Soybeans	■ US China trade war ■ Renewed Covid lockdowns

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