COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

18 OCTOBER 2021

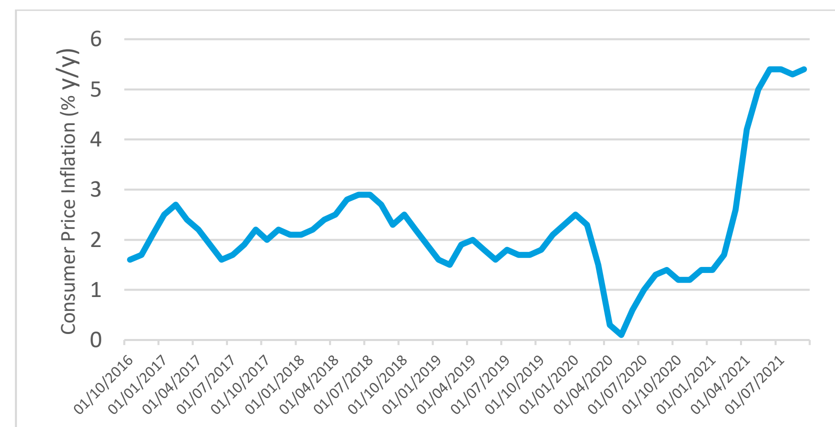
A momentary lapse of disinflation.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.58%	-3 bps	-0.1%	-2.8%
German Bund 10 year	-0.16%	0 bps	0.0%	-2.9%
UK Gilt 10 year	1.13%	-3 bps	0.0%	-7.7%
Japan 10 year	0.10%	1 bps	0.0%	-0.1%
Global Investment Grade	92 bps	0 bps	-0.1%	-1.1%
Euro Investment Grade	87 bps	1 bps	-0.2%	-0.6%
US Investment Grade	89 bps	-1 bps	-0.1%	-1.2%
UK Investment Grade	90 bps	1 bps	-0.4%	-3.8%
Asia Investment Grade	201 bps	1 bps	-0.5%	-0.5%
Euro High Yield	332 bps	1 bps	-0.5%	3.1%
US High Yield	312 bps	-8 bps	-0.2%	4.5%
Asia High Yield	840 bps	13 bps	-6.0%	-11.9%
EM Sovereign	325 bps	-1 bps	-0.2%	-1.7%
EM Local	5.5%	4 bps	0.4%	-6.0%
EM Corporate	303 bps	-2 bps	-0.5%	1.0%
Bloomberg Barclays US Munis	1.1%	-1 bps	-0.1%	0.7%
Taxable Munis	2.3%	-4 bps	0.2%	1.0%
Bloomberg Barclays US MBS	25 bps	0 bps	-0.2%	-0.9%
Bloomberg Commodity Index	223.06	2.1%	3.9%	34.2%
EUR	1.1581	0.3%	0.2%	-5.0%
JPY	114.43	-1.8%	-2.6%	-9.6%
GBP	1.3742	1.0%	2.1%	0.6%

Source: Bloomberg, Merrill Lynch, as at 18 October 2021.

Chart of the week: US Consumer Price Inflation, 2016-2021



Source: Bloomberg, Columbia Threadneedle Investments, as at 15 October 2021.

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Macro / government bonds

Core government bond yield movements were mixed, with rising yields in the first half but with enough of a recovery in the second half that yields finished lower for the week. This was less about any specific data release and more about the amount of bad news already priced into market levels.

A combination of supply chain interruptions as well as surging commodity prices and an increase in wages has pushed up costs for companies, some of which has been levied in turn on consumers. The 0.4% rise consumer price inflation from the US was elevated by higher food and housing costs while used car prices (which had been very strong), clothing and air fares were lower. At a core level (ex food and energy), the rise was a more modest 0.2%. This means at annual rate consumer prices are growing at 5.4%, the highest rate since 2008 and a huge leap higher from the 0.1% y/y recorded 18 months earlier: **see chart of the week.**

While inflation is rising unemployment is falling with last week's US initial jobless claims data marking another post pandemic low of 293k.

Investment grade credit

Corporate bond markets have lacked the volatility seen in government bonds these last few months and have displayed little directionality though there has been some decompression of spreads with riskier areas of the market underperforming after robust performance earlier in the year.

Results season kicked off last week with the US banks. In general numbers were encouraging with profitability at or above 2019 levels. It's been driven by a very benign credit environment, offset by margins that have stabilised and are starting to recover mildly. Loan growth has started to come through on the corporate side (ex PPP). Capital return plans are much more developed than Europe, which has been falling mildly this quarter.

High yield credit

European high yield posted basically a flat performance last week with CCCs outperforming BBs as the former posted a positive performance compared to the latter's negative number. It was a week of two halves as it started with commentary that high yield brokers had been told to lower their high yield risk. This resulted in lower market liquidity and lead to exacerbated moves, in either directions. However, in the second half of the week, spreads tightened in, modestly, the first time in four weeks, as the asset class showed some stabilisation and improved market interest. Still, flows continue to be negative, exiting from both ETFs and managed accounts. The primary market slowed down with only two offerings, albeit jumbo, for a total for €2.9bn.

In stock specific news, Boparan, the UK chicken producer issued a press release outlining the sharp increase in business costs citing, for example, agricultural feed (+15%), energy and C02 costs (+500%), as well as labour (+15%.) Days of chicken costing less than a pint of beer appeared to be numbered. In other news, PureGym announced it has shelved IPO plans, for now. In ESG, Ineos, the chemical company announced a $2.3bn plan to invest in green hydrogen. Finally, Adler, the German real estate group who headlined last week, on accusations and concerns of improper property transactions and inappropriate property valuation saw its rating cut two notches to B+ by S&P. The rating agency cited business uncertainty and tightening liquidity. Interestingly, at the same time, Peach Property, another German real estate firm, was upgraded to BB- from B+ on growing asset base and robust operating performance.

In M&A news, the Australian gaming company, Aristocrat Leisure, announced it is buying Playtech for AU$5bn, a part cash, part equity deal.

US high yield bond prices dipped initially but ultimately recovered over the week amid positive earnings and ongoing volatility in stocks, rates and commodities. The ICE BofA US HY CP Constrained Index returned 0.18% and spreads were 9bps tighter. Primary issuance slowed to $5.8bn this week, with the US holiday on Monday as well as the recent price volatility. According to Lipper, the asset class experienced its largest retail outflow since June with $1.8bn of withdrawals over the week.

Leveraged loans

Leveraged loan prices were modestly lower over the week. The average price of the J.P. Morgan Leveraged Loan index declined $0.01 off the year-to-date high as the asset class continues to decouple from macro driven moves; loans had significantly outperformed fixed income alternatives over the preceding three weeks' stretch of rising rates. Meanwhile, the retail loan fund base posted its 39th inflow in 40 weeks ($560m) with year-to-date inflows totalling $37bn.

Structured credit

The US Agency MBS market posted a small return last week, up 7bps and underperforming other high-quality bonds. Mortgages mostly tightened on the week with demand focused on the 3% coupon as the market has now settled into taper expectations. On the whole, origination of conventional mortgages has been declining with 3Q new mortgages down roughly $111bn, marking the third consecutive quarter of decline. Also, of note are losing lending standards across LTV and DTI requirements as well as FICO scores as the recovery continues.

The CMBS market has been dealing with above-average supply. Spreads were relatively range-bound last week but versus a month ago are roughly 5-20 bps wider. Fundamentals have improved with retail rent collection at 90% and hotel occupancy/rates at 80% of 2019 levels.

Asian credit

Modern Land China has launched a consent solicitation to extend the maturity date of its 12.85% bond (maturity on 25 October 2021) by three months to 25 January 2022. The company will also redeem the $87.5m (35% of the outstanding principal amount) on 25 October. This consent solicitation is viewed as a distressed debt exchange according to Fitch, which downgraded Modern Land China from B to C.

S&P downgraded several Macau gaming companies due to the slow recovery in gaming revenue and its expectation that a fully recovery to pre-pandemic level may only happen in 2023 (previous expectation: 2022). S&P downgraded Melco Resorts from BB to BB- with a Negative Outlook. It also downgraded Studio City and Wynn Macau from BB- to B+ with a Negative Outlook.

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Emerging markets

In China, the PBOC said the Evergrande risks are “controllable”, the bank pledged support for consumers and the resumption of construction. The PBOC also injected 500bn yuan of liquidity into the financial system to match maturing loans. On a less positive note, China’s year-on-year GDP disappointed at 4.9%.

In Chile the central bank hiked interest rates 1.25% to 2.75%, with inflation expected to hit 5.7% in December. Chile has suffered from a weaker currency and high demand for government stimulus.

In Turkey, the Lira hit record lows against the US dollar as Erdogan removed two deputy governors from the central bank, one of whom voted against a rate cut at the last meeting. Turkey is expected to cut rates at this week’s meeting despite surging inflation.

Commodities

Industrials metals drove the market rally with a 10.3% rise, as high energy costs continue to curtail metal output; zinc rallied 20.5% with Asian stocks hitting the highest level since 2007. Glencore announced its lowering European Zinc output and China continue to restrict production. Copper also rallied 10.6% and is approaching all time highs.

Natural gas eased slightly at (-1.9%) following milder weather forecasts for the US throughout October. Elsewhere brent rallied 3.0% to trade above $85 as companies rush to secure fuel as a substitute for gas.

Responsible investments

The Australian Prime Minister has now confirmed he will be attending the COP26 climate negotiations later this month in the UK, after making suggestions he might skip it. Local climate activists slated his hesitation to attend as Australia is currently ranked among the worst countries for its climate policies and emissions reductions. It’s been rumoured that China’s President Xi Jinping is unlikely to attend as it’s believed he’s not left the country since early 2020 due to Covid regulations. Chinese officials reported that they have not entirely ruled out a change of plans and often leave announcing his travel plans until the last minute.

The EU’s first ever Green Bond was launched last week and took second spot in the leader board for largest ESG bond issuance ($290bn). The use of proceeds are set to cover around a third of the bloc’s pandemic recovery package. Member states will need to submit payment requests as they reach environmental targets.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

18th October 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 £ €	▪ Yields have broken out of their earlier tight ranges but likely to remain capped by structural downtrend in real yields and growth ▪ 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	▪ Inflation becomes more persistently entrenched, warranting much higher rate structure ▪ 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$ $	▪ The US leads the way on the economic recovery from the pandemic, which drives a monetary wedge between the Federal Reserve and ECB ▪ Window for dollar underperformance has narrowed as central banks globally turn more hawkish on inflation expectations at the expense of growth	▪ Re-acceleration of global growth forecasts led by reversal of China credit contraction ▪ 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 ▪ o/w Oil	▪ US China trade war ▪ Renewed Covid lockdowns ▪ Global Recession

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