INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

# In Credit

24 JANUARY 2022

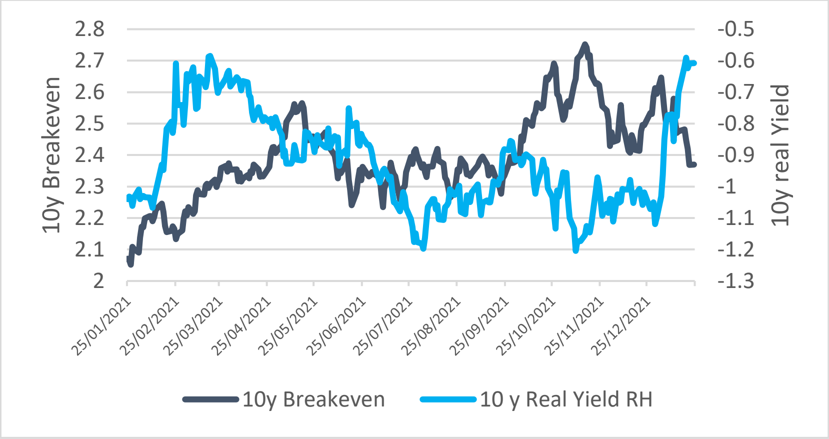
## The rise in yields is real.

### Markets at a glance

| | Price / Yield / Spread | Change 1 week | Index QTD return | Index YTD return |
|---|---|---|---|---|
| US Treasury 10 year | 1.73% | -6 bps | -1.6% | -1.6% |
| German Bund 10 year | -0.09% | -5 bps | -0.5% | -0.5% |
| UK Gilt 10 year | 1.13% | -2 bps | -2.2% | -2.2% |
| Japan 10 year | 0.14% | 0 bps | -0.3% | -0.3% |
| Global Investment Grade | 104 bps | 4 bps | -1.8% | -1.8% |
| Euro Investment Grade | 101 bps | 2 bps | -0.6% | -0.6% |
| US Investment Grade | 103 bps | 6 bps | -2.3% | -2.3% |
| UK Investment Grade | 98 bps | 3 bps | -1.4% | -1.4% |
| Asia Investment Grade | 187 bps | -4 bps | -1.3% | -1.3% |
| Euro High Yield | 348 bps | 15 bps | -0.4% | -0.4% |
| US High Yield | 329 bps | 20 bps | -1.5% | -1.5% |
| Asia High Yield | 720 bps | -67 bps | -3.6% | -3.6% |
| EM Sovereign | 346 bps | 4 bps | -2.5% | -2.5% |
| EM Local | 5.9% | -1 bps | 0.6% | 0.6% |
| EM Corporate | 316 bps | 5 bps | -1.3% | -1.3% |
| Bloomberg Barclays US Munis | 1.4% | 10 bps | -1.4% | -1.4% |
| Taxable Munis | 2.6% | -1 bps | -1.8% | -1.8% |
| Bloomberg Barclays US MBS | 25 bps | -11 bps | -1.5% | -1.5% |
| Bloomberg Commodity Index | 224.52 | 1.8% | 6.2% | 6.2% |
| EUR | 1.1325 | -0.6% | -0.2% | -0.2% |
| JPY | 113.60 | 0.5% | 1.3% | 1.3% |
| GBP | 1.3521 | -0.9% | 0.2% | 0.2% |

Source: Bloomberg, Merrill Lynch, as at 24 January 2022.

### Chart of the week: US 10-year real yields and inflation expectations




Source: Bloomberg, Columbia Threadneedle Investments, as at 24 January 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

A degree of calm returned to core bond markets last week. The market continues to 'price-in' tighter monetary policy conditions unsure it would seem as to what the US Federal Reserve's newly-found hawkishness actually means in absolute terms. The shape of the sell-off is interesting though. This is being built through higher real yields rather than any change in inflation expectations. Indeed, expectations have actually fallen this year (see **chart of the week**). A possible brake for the sell-off is its impact on 'risk assets'. It is notable that equities have fallen this year with the tech-heavy Nasdaq index now in correction territory (ie, a more than 14% fall from peak). This reflects the increase in the discount rate that these higher real yields bring.

In the wake of the prior week's US inflation date (7% y/y), the UK joined the club of economies with outsized consumer price inflation rises. In December, CPI rose by 5.4%, which was the highest in 30 years, higher than last month, and in excess of expectations by two tenths. Meanwhile, unemployment also fell to 4.1%, which was above expectations. So good news on the jobs front but not for real wages growth where there appears to be a harsh cost of living crisis brewing. The eurozone followed suit with a 5% print on inflation, which was the highest since the formation of the single currency.

This week is fairly data / event heavy with the Fed's preferred measure of wages (the Employment Cost Index), the first estimate of US GDP and PMIs globally as well as the FOMC meeting to look forward to. In Europe there is a Presidential Election in Italy, and the UK should get the Rose report on the 'partygate' saga.

## Investment grade credit

The prospect of higher interest rates is hardly positive for spread markets and, in line with other risk assets, spreads gave up some ground last week. The move thus far has been modest with global investment grade spreads only a few basis points (and 4%) wider this year.

In company specific news, Microsoft announced the large-scale purchase of Activision Blizzard last week. This brings online gaming content to its portfolio in the shape of games such as 'Call of Duty'. Spreads for the AAA rated issuer drifted a few basis points wider.

## High yield credit & leveraged loans

US high yield bond prices declined during the week and have retreated in 10 of 13 sessions to begin the year, alongside a sharp increase in Treasury yields and weakness in equities. The narrative remains unchanged, with investors focused on the prospect of tighter Federal Reserve policy in the face of high inflation and 44 earnings seasons, which is off to mixed results. The ICE BofA US HY CP Constrained Index returned -0.71% and spreads were 19bps wider over the week. Meanwhile, according to Lipper, high yield retail funds reported $2.1bn outflows for the week, after $2.2bn exited the prior week.

The steady rise in the average price of the J.P. Morgan Leveraged Loan Index continued this week as demand for floating rate debt has benefited from a resetting of Fed expectations. Specifically, the asset class a record high weekly inflow of $2.3bn over the week following a $1.8bn contribution during the prior week. Leveraged loan prices increased $0.10 to a three-year-high $98.95.

European High Yield (EHY) continued 2022 with another week of spread widening and yield rising resulting in spreads +8 bps and yields higher by 0.16% since the start of the year. CCC rated credit underperformed BBs, returning -1% for the week, 3x worse than BBs. EHY net flows turned decidedly negative, both for ETFs and managed accounts but also showed the increasing preference for short maturities as short duration funds experienced inflows. Markets saw steady selling with a risk reduction preference especially for longer duration securities. That combined with a big pick up in the primary market (€3.3bn over seven new issues) put some pressure on spreads but the market remained relatively well balanced with no forced selling.

In credit rating news, TalkTalk was downgraded to B+ by Fitch on the back of a deteriorating leverage story. On the M&A front, JKO has withdrawn its offer for Playtech, leaving the way clear for Aristocrat's (better-rated) bid; this was supportive of the bonds. In Italy, Atlantia confirmed buying UNEX, a traffic management business, for €950m, while news was out that Vodafone and Iliad are in discussions to merge their Italian businesses.

On the story of Rising Stars / Fallen Angels, 2021 was noted for the decisive pick up in the former. There was a record €31.3bn of rising stars which represents 9.6% of the BBs in EHY. That compares to €11.6bn of fallen angels. The upward rating drift looks to continue in 2022.

## Asian credit

Last week, the PBOC implemented additional policy easing by lowering the 7-day repo rate and the 1-year medium-term lending facility (MLF) by 10bps to 2.1% and 2.85% respectively. With respect to the loan prime rate (LPR), the PBOC also cut the 5-year LPR (reference for mortgages) by 5bps to 4.6% and the 1-year LPR by 10bps to 3.7%.

The Ministry of Housing and Urban-Rural Development (MHURD) and other ministries are drafting new rules on the supervision of pre-sales funds in escrow accounts. This could potentially ease the access of Chinese property companies to the pre-sales funds and lower the liquidity stress in the sector. Another positive development is Country Garden's issuance of HKD3.9bn convertible bonds, which demonstrates that the company continues to maintain access to the debt market. However, there were several ratings downgrade in the property sector. S&P downgraded Agile Group, Sunac and Times China to reflect their tight liquidity positions amid the restrictive regulatory environment.

## Structured credit

The US Agency MBS market posted another negative return on the week, down 6bps. Mortgages underperformed other duration sensitive assets, with OAS about 6bps wider on liquid coupons. CMBS spreads drifted wider at the top of the stack but broadly speaking the sector outperformed risk markets. New remittance reports evidenced continued improvement in fundamentals with a reduction in the delinquency percentage to 4.8%. Demand has been robust for lower in the capital structure bonds; CLO demand is seemingly insatiable. As the Fed pivots towards a hiking regime, investors can't get enough of the sector that is currently exhibiting a negative correlation to high yield bonds, an unusual phenomenon.

## Emerging markets

In China the People's Bank of China cut the 1-year and 5-year prime loans by 10bps and 5bps respectively. The 5-year rate hasn't been cut since April 2020. In response to slowing growth, the PBOC is responding with further easing following the previous cut to the RRR rate in December. In issuance news, EIG Pearl Holdings (Saudi Aramco pipelines) raised $2.5bn, a reduction from the previous target of $3.5-4.4bn.

On the Russian / Ukrainian front, tensions stepped up as the US and UK are withdrawing embassy staff from Kyiv due to the threat of a Russian invasion.

In central bank news, Malaysia kept rates on hold at 1.75%, as Q3 GDP contracted by 4.5%, the bank viewed downside risk to growth as a key concern. In Sri Lanka, rates were raised by 50bps to 6.5% as inflation is surging above 12%. Elsewhere, Turkey held rates at 14% and Ukraine hiked by 100bps.

## Commodities

Commodities had another strong week rallying 1.8%. Nickel (+8.5%) and Tin (+9.1%) were the top performers, as Nickel surged to its highest level since 2011 due to a combination of strong demand for electric vehicle batteries and supply shortfalls. Goldman Sachs recently upgraded its nickel target from $13,000 a tonne (In August in 2021) to $30,000.

Brent rallied 1.9%, finishing the week just shy of $88 a barrel. Brent has been supported by resilient demand in spite of the Omicron variant and producers struggling to bring supply back online. Oil was also supported by rising geopolitical tensions on the Russian/Ukrainian boarder and in the UAE. Yemen's Iranian backed Houthi militants fired two ballistic missiles at the UAE. The attack follows last week's drone and missile attack on Abu Dhabi killing three people.

# Summary of fixed income asset allocation views

## Fixed Income Asset Allocation Views

24th January 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.<br>▪ 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.<br>▪ 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.<br>▪ 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)**<br>('P' = Periphery) | P<br>¥ $<br>Short -2 -1 0 +1 +2 Long<br>£<br>€ | ▪ Carry offered by front end yields now attractive<br>▪ Longer yields continue to be capped by long-run structural downtrends in real yields<br>▪ Inflation likely to normalize over medium term<br>▪ Hiking cycles to be shortened by easing inflation and moderating demand<br>▪ ECB to lean against rising financing rates | ▪ Inflationary dynamics become structurally persistent<br>▪ Labour supply shortage persists; wage pressure becomes broad and sustained<br>▪ Fiscal expansion requires wider term premium<br>▪ Long run trend in safe asset demand reverses |
| **Currency**<br>('E' = European Economic Area) | ¥<br>EM<br>A$<br>Short -2 -1 0 +1 +2 Long<br>$<br>£<br>E | ▪ There is room for the Dollar to strengthen further given our belief in the US leading the economic and monetary policy recovery<br>▪ However, experience of past cycles suggests the Dollar fares less well at the start of a cycle, turn neutral USD for now | ▪ The ECB moves to tighten monetary policy<br>▪ The Fed starts to push back against market pricing<br>▪ More expansive China credit cycle |
| **Emerging Markets Local (rates (R) and currency (C))** | R<br>Under-weight -2 -1 0 +1 +2 Over-weight<br>C | ▪ Selective opportunities<br>▪ Dollar resilience may crimp scope for EMFX performance<br>▪ EM real interest rates relatively attractive, curves steep in places | ▪ Central banks tighten aggressively to counter fx weakness<br>▪ EM inflation resurgence<br>▪ EM funding crises drive curves higher and steeper<br>▪ 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<br>▪ DM tightening financial conditions will unevenly impact EM credit and EMFX as many countries have already responded to inflation through hikes<br>▪ 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.<br>▪ 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<br>▪ A replay of 2013 occurs with a taper tantrum or swift appreciation of the USD<br>▪ Growth scars from COVID persist and hurt commodity prices & ability to grow out of deficits.<br>▪ 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.<br>▪ 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.<br>▪ 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.<br>▪ 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<br>▪ Bank loans are attractive as they have shown better performance relative to corporates, although flows amid hiking expectations have increased valuations<br>▪ The best performing parts of these sectors have been the most volatile and lowest quality.<br>▪ 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.<br>▪ Waves of ratings upgrade begin to occur into this year.<br>▪ 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.<br>▪ Valuations continue to widen on hawkish language; however, valuations remain rich and carry in many Specified Pools and CMO deals remain unattractive.<br>▪ Spreads still tight to similar Fed taper and QT regimes<br>▪ 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.<br>▪ 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<br>▪ Spread tightening seems somewhat excessive per credit quality but seeing repricing risk premiums in new issues.<br>▪ Keeping an eye on sentinel slight upticks in defaults<br>▪ 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.<br>▪ CMBS: Most segments maintain strong fundamentals with retail & hospitality improving. Spreads outperforming other structured segments.<br>▪ CLOs: Attractive with fundamentals, waiting for issue pickup | ▪ Attractive shorter duration deals coming into market, provide less carry<br>▪ Changes in consumer behavior in travel and retail last post-pandemic.<br>▪ Work From Home continues full steam-ahead post-pandemic (positive for RMBS, negative for CMBS).<br>▪ SOFR transition slows CLO new issuance<br>▪ 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<br>▪ u/w Livestock<br>▪ u/w Gold<br>▪ o/w Oil<br>▪ o/w Natural Gas | ▪ Renewed Covid lockdowns<br>▪ 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 24.01.2022, 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