COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

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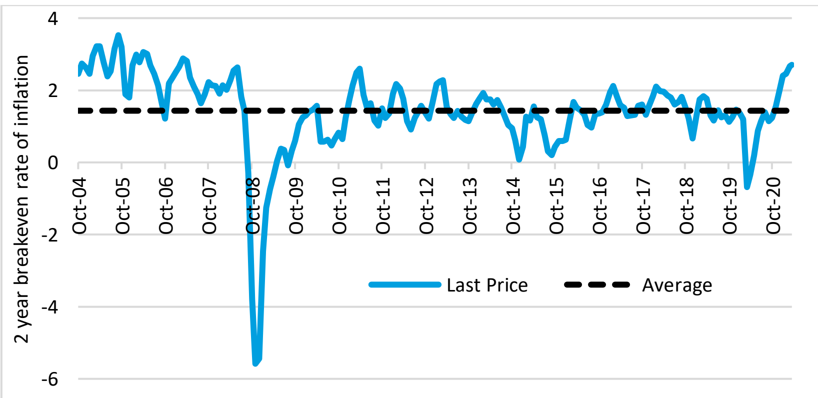
Great Expectations.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.59%	-7 bps	1.1%	-3.6%
German Bund 10 year	-0.23%	8 bps	-0.3%	-2.6%
UK Gilt 10 year	0.77%	-1 bps	1.1%	-6.5%
Japan 10 year	0.09%	-2 bps	0.2%	-0.2%
Global Investment Grade	96 bps	1 bps	1.0%	-2.4%
Euro Investment Grade	86 bps	-1 bps	0.2%	-0.6%
US Investment Grade	94 bps	0 bps	1.4%	-3.1%
UK Investment Grade	93 bps	-1 bps	0.9%	-3.2%
Asia Investment Grade	226 bps	16 bps	-0.9%	-1.7%
Euro High Yield	305 bps	-6 bps	0.6%	2.2%
US High Yield	322 bps	-2 bps	1.0%	1.9%
Asia High Yield	558 bps	17 bps	-0.1%	0.1%
EM Sovereign	312 bps	-7 bps	2.2%	-2.6%
EM Local	4.9%	-6 bps	2.5%	-4.3%
EM Corporate	302 bps	4 bps	0.5%	-0.3%
Bloomberg Barclays US Munis	1.0%	-8 bps	0.9%	0.6%
Taxable Munis	2.3%	-6 bps	2.1%	-2.4%
Bloomberg Barclays US MBS	8 bps	-3 bps	0.5%	-0.6%
Bloomberg Commodity Index	185.44	3.0%	3.7%	10.9%
EUR	1.2035	0.7%	2.2%	-1.9%
JPY	108.12	0.8%	1.8%	-5.0%
GBP	1.3936	0.9%	0.4%	1.2%

Source: Bloomberg, Merrill Lynch, as at 16 April 2021.

Chart of the week: US two-year inflation expectations (2004-2021)



Source: Bloomberg, Columbia Threadneedle Investments, as at 14 April 2021.

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Macro / government bonds

Inflation arrived in the US last week. There was also a bumper crop of strong economic data releases. This had been largely expected and remarkably yields fell to the lowest level in a month with the US 10-year dipping well under 1.6%. ‘It is better to travel hopefully than arrive’ as Robert Louis Stevenson might have put it.

Consumer price inflation rose by 0.6% last month taking the inflation rate to 2.6% y/y (core rate 1.6% y/y). Energy prices rose over 9%, hotel rates were up nearly 4% while car insurance rose over 3%. As the economy reopens, pent up demand for services and supply shortages are expected to add to base effects to force inflation higher, over the short term. What matters to the market though is how this reality compares to expectations. We have noted several times that inflation expectations have moved by a very substantial amount in the last 12 months or so. Indeed, the two-year breakeven rate has risen from around -0.5% in April of 2020 to 2.7%. That 3+% shift in expectations is (aside the GFC) the largest we can find historically (**see chart of the week**)**.** Long-term (10-year) inflation expectations have risen but not by as much (around 1.75%) and have barely moved in the last few weeks. For us, the long-term secular forces of disinflation remain in place. The effects of globalisation, technology, demographics and deunionisation have not been unwound and inflation is likely to remain low in the longer term.

In other news, retail sales came in at plus 9.8% in one month (4% better than expected!); initial claims fell to the lowest level since the pandemic and the Philly Fed survey rose to the highest point since the early 1970s. This reflects the vaccine roll out and restart of the economy and the optimism that accompanies this.

Investment grade credit

Spread volatility continues to decline and credit markets moved sideways last week.

The positive effects of easy policy conditions, improving economic performance and credit fundamentals are supportive for the market. Spreads are fully valued at present levels and now well below short (five-year) and long-term (20-year) averages by around 1.1 and 0.6 standard deviations respectively for the global index.

The results season is upon us once again; last week brought updates from the major US banks (ie, JP Morgan, Wells Fargo, Citigroup, and Bank of America). In general, it was a very positive story and one of increased return on equity, helped by writebacks (from earlier provisioning) with strong capital ratios but very low loan to deposit ratios (a lack of lending). Margins remain under pressure in the low rates environment. Risks, from a credit perspective, would appear to centre on the extent of equity-friendly behaviour (share buy-backs) that these institutions embark on.

High Yield Credit

US high yield bond prices oscillated over the past week amidst a new high for the S&P 500, strong US economic data and an unexpected decline in US treasury yields. The ICE BofA US HY Cash Pay Constrained Index returned 0.25% with spreads effectively unchanged. The yield-to-worst on the index declined 7bps to 3.96%. According to Lipper, the asset class reported a modest outflow of $132m. Another $12bn of new issuance priced over the week as issuers continue to take advantage of near record asset class yields.

It was a solid week for European high yield with CCCs strongly outperforming. Flows were negative as ETF outflows dominated even as managed accounts experienced modest inflows.

It was a very heavy primary week with issuance of €6bn across eight deals. Given the strong market demand for yield, all the deals priced well, at or close to fair value, and were oversubscribed.

Positive credit rating news for Netflix with the double upgrade to Ba1 by Moody's. This brings the rating in line with S&P and sets Netflix as a future rising star. There was bad news for Ellaktor, which was downgraded to CCC+ with negative outlook, driven by concerns around the construction business and inadequate ring fencing at the bondholder restricted group level.
There was positive news for the Covid-impacted travel sector as Easyjet announced late May pick-up in capacity while Avis, the car rental group reported strong pick-up in demand.
The Atlantia-Autostrade saga continues as ACS (the Spanish infrastructure company) announced that it plans to make a competitive bid for Autostrade by May 20. There are also rumours of a bid from another Italian firm (Toto) with Apollo, the private equity group.

Leveraged loans

Leveraged loan prices were mixed over the past week and reside $0.13 below the year-to-date high seen in late February. The average price on the J.P. Morgan Leveraged Loan index was unchanged at $98.33 with the average price for BB loans increasing $0.05 to $99.49, Single B loans decreasing $0.02 to $99.20, and Split B/CCC flat at $90.38. Inflows continued with a $1.08bn contribution for the week, the largest since January.

US structured credit

Agency RMBS had a strong week, up 25bps, on rallying rates and solid demand. Strong economic data didn't sway investor appetite and mortgages continued to run alongside equities. Higher coupons outperformed on improved carry. On the origination front, Q1 volumes came in at approximately $750bn, the second highest quarter after Q4,2020. On the non-agency side, improvements in delinquencies have stalled; however, forbearance rates continue to decline. Residential fundamentals remain strong given the state of the US housing market and (still) low rates. In CMBS, conduit spreads stood at 60bps, 115bps, 170bps, and 360bps for AAAs, AAs, As, and BBBs respectively (as at 9 April), representing tightening across the quality spectrum with BBBs improving the most. Nine private-label CMBS deals totaling $6.6bn priced in March 2021, which is 73.1% higher year-on-year.

Asian credit

The State Administration for Market Regulation (SAMR) issued a penalty of CNY18.2bn ($2.8bn) on Alibaba Group Holding, which concludes SAMR's investigation on Alibaba for engaging online merchants to sell on its ecommerce platform. The penalty amounts to around 4% of Alibaba's revenues in 2019, which the company can easily pay given its strong liquidity position ($70bn of cash and equivalents and short-term investments). The penalty also potentially lowers the risk of more punitive consequences from the Chinese government. However, the government's scrutiny on anti-monopolistic practices will likely result in higher competition for the largest e-commerce platforms because online merchants will have more flexibility to sell on other competing platforms. SAMR has also ordered 34 of China's largest technology companies (include Tencent, JD.com, Meituan, Pinduoduo, Kuaishou, Didi Chuxing) to conduct their businesses in compliance with the nation's anti-trust regulation. These companies are required to submit their self-examinations and rectifications steps within one month.
S&P downgraded Li & Fung Ltd to BBB- with an outlook stable because its financial buffer has been eroded by lower EBITDA and negative cash flow. Li & Fung restructured its trading business in 2020, which will likely generate lower but steadier EBITDA from 2021.

Emerging markets

Emerging market debt saw $1.3bn of inflows last week driven by hard currency debt, which takes year-to-date inflows to $32bn.
The key event of the week was the US sanctions on Russia in response to the “SolarWinds” cyber-attack and interference in the 2020 election. The sanctions bar US financial institutions from buying rouble-denominated government bonds in the primary market. However, only 10% of local Russian bonds go to foreigners. The story follows the theme of tension with Russia following Russian troops massing on the Ukrainian boarder and the recent expulsion of 18 Russian diplomats from the Czech Republic, having been linked to the explosion of a Czech arms depot.

Elsewhere in EMs, Huarong Asset Managed bonds rallied following China’s financial regulator stating that the company was operating normally and has ample liquidity. May 2022 notes climbed to 85 cents on the dollar from 65. In central bank news Turkey held rates at 19.0% while Ukraine hiked rates 100bps to 7.5%.

Commodities

Energy markets had a strong week rallying 5.6% overall; the rally consisted of a 5.3% rise in natural gas and a 6.4% WTI rally. Natural gas prices have been supported by colder weather in the US. On the supply front, the IEA estimate oil inventories now stand at 57 million barrels above 2015-19 averages, this compared to the 249 excess in July 2020. This has been supporting crude prices.

Agricultural commodities also had a solid week with corn (1.9%), wheat (3.7%) and soybeans (1.8%) all rallying. Corn rose to its highest levels since 2013 driven by weather concerns delaying the most recent Brazilian crop and snowy conditions in the US slowing both corn and soybean planting and delaying wheat growth. Elsewhere in China the resurgence of African swine fever threatens to curtail the rally in corn and soybeans (key feedstocks).

Responsible Investments

Ferrari announced last week it will design and produce its first fully battery powered vehicle for release in 2025. Ex-CEO Louis Camilleri had said in 2019 Ferrari would never be 100% electric and that “customers have difficulty imagining a real Ferrari which is fully electric”. The company may struggle to re-produce an electric version of the signature Ferrari engine rumble, but perhaps this move to a fully electric vehicle will appeal to those with a taste of both luxury supercars and saving the planet.

As part of its plans to become carbon neutral by 2030, Apple has launched a $200m Restore Fund that will invest in forestry projects worldwide. This aims to remove one million metric tons of carbon dioxide from the atmosphere each year, while providing a financial return to investors. Apple has already been using 100% responsibly sourced materials for its packaging for the last three years. This recent project is partnered with a US based environmental organisation, Conservation International, who will be co-investing and Goldman Sachs, who will be managing the fund.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

19th April 2021

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	■ 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 better than they went into 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, & the labour market widen the range of outcomes for spreads in one year's time.	■ 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 China relationship, which has not meaningfully improved with a new US Administration.
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +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)	£ ¥ 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	■ 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	■ 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 pockets of value still exist. ■ CMBS: a return to normalcy won't look 'normal' for sectors like office space or convention hotels, but pockets of value still exist in these and other areas (but there are simply fewer opportunities than 6 months ago) ■ Our preference remains for non-agency RMBS in this area.	■ Changes in consumer behavior 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, butseems 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 ■ o/w Softs	■ US China trade war

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