INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

10 JANUARY 2022

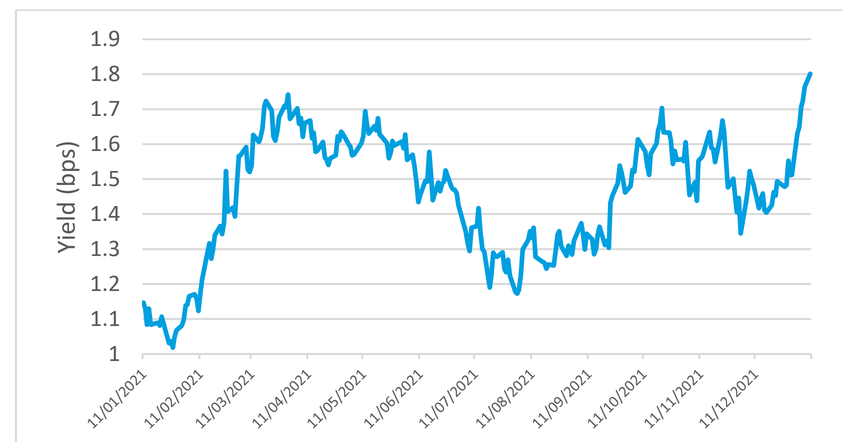
Stumbling out of the blocks.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	1.78%	27 bps	-1.7%	-1.7%
German Bund 10 year	-0.04%	14 bps	-0.8%	-0.8%
UK Gilt 10 year	1.18%	21 bps	-2.2%	-2.2%
Japan 10 year	0.14%	7 bps	-0.3%	-0.3%
Global Investment Grade	97 bps	-3 bps	-1.3%	-1.3%
Euro Investment Grade	96 bps	-2 bps	-0.4%	-0.4%
US Investment Grade	95 bps	-3 bps	-1.7%	-1.7%
UK Investment Grade	95 bps	-3 bps	-1.2%	-1.2%
Asia Investment Grade	181 bps	-7 bps	-0.7%	-0.7%
Euro High Yield	328 bps	-12 bps	0.1%	0.1%
US High Yield	320 bps	10 bps	-0.9%	-0.9%
Asia High Yield	695 bps	38 bps	-2.5%	-2.5%
EM Sovereign	331 bps	1 bps	-1.7%	-1.7%
EM Local	5.9%	14 bps	-0.7%	-0.7%
EM Corporate	301 bps	-11 bps	-0.6%	-0.6%
Bloomberg Barclays US Munis	1.3%	15 bps	-0.7%	-0.7%
Taxable Munis	2.5%	22 bps	-2.4%	-2.4%
Bloomberg Barclays US MBS	31 bps	0 bps	-1.1%	-1.1%
Bloomberg Commodity Index	217.50	2.1%	2.1%	2.1%
EUR	1.1331	-0.1%	-0.1%	-0.1%
JPY	115.62	-0.4%	-0.4%	-0.4%
GBP	1.3590	0.4%	0.4%	0.4%

Source: Bloomberg, Merrill Lynch, as at 10 January 2022.

Chart of the week: US 10-year yield (LTM)



Source: Bloomberg, Columbia Threadneedle Investments, as at 10 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

It has not been a good start to the year. Core government bond yields have risen very rapidly with the benchmark 10-year US treasury yield increasing by almost 30bps in the space of five trading sessions **(see chart of the week).**

Why so? Recent news (both fundamental and on the virus front) suggests ongoing economic strength/inflationary pressures, which will require a more robust policy shift; while evidence supports the idea that the omicron variant is not as medically dangerous as its predecessor. In this light, the US Federal Reserve intimated that not only will rates need to rise, and by more than thought barely a few weeks ago, but that it is looking at starting to dismantle its swollen balance sheet in the not-too-distant future. None of this made for happy reading for risk-free assets.

The week also ended on a 'sour note' with the US employment report showing that the rate of unemployment had fallen to below 4% (3.9%), its lowest level since before the pandemic and effectively at full employment. Also, rather worryingly, wages rose more than expected; all in all raising the chances of a March rate hike to near certainty.

Dissecting the move higher in yields, it was real yields rather than a further rise in inflation concerns that pushed prices lower to revisit levels not seen since March of last year. This implies that the move is more about policy catch-up than further fears of inflation. Yields are now over 1.7% at the 10-year point of the curve. Europe and the UK did not escape the carnage. Bund yields, once well below 0% yield, are now perilously close to that psychologically significant point while UK gilts remain on an upward yield trend.

This week's critical data release will be the US consumer price index barometer of inflation. We expect to see a moderation of the monthly increase though the headline rate should come in around 7% y/y, which would be the highest rate of inflation since the early 1980s.

Investment grade credit

At least in spread terms, it has been a better start to the year for credit markets than their government bond cousins. Market spreads are tighter even as equities are lower and US high yield spreads wider (see below). Perhaps this says something about investor positioning. So, as we ended the first week, spreads have effectively rebounded and cut the Q4,2021 spread widening in half with global spreads now back below 100bps.

New issuance has also picked up with this more positive sentiment and the opening of markets post holiday season. This issuance has been found in all major markets but has been more focused at this stage on banks than corporates. We expect the heavy supply pipeline to continue this week and to weigh on markets in the immediate term. Longer term we expect net supply to wane and to be more benign than last year, which will support the market.

In company specific news, datacentre giant Digital Realty announced the purchase of a majority stake in one of Africa's largest centres (Teraco) last week. There was also a rekindling of speculation of some kind of tie-up between French supermarket chains Auchan and Carrefour. This week brings the start of US earnings season with major banking groups such as Citigroup, JPMorgan, and Wells Fargo reporting results.

High yield credit & leveraged loans

US high yield bond prices reversed a large portion of December's gains over the past week as investors absorbed hawkish Fed minutes and a sharp increase in treasury yields to begin 2022. That said, spreads were only moderately wider and reside a mere 15bps above late December's multi-year tight despite the repricing. The ICE BofA US HY CP Constrained Index returned -0.94% and spreads were 11bps wider. Capital markets slowly reopened over the week with a manageable $6.0bn of issuance. According to Lipper, the asset class reported a $584m retail fund inflow.
On the other hand, the average price of the J.P. Morgan Leveraged Loan index rose $0.18 over the week despite the setback for high yield bonds, as the sharp rise in rates boosted the appeal of floating-rate products. Retail loan funds experienced an $840m inflow.

European high yield had a firm start for 2022 as spreads narrowed and yields fell the first week of the year. The travel and leisure sectors led the market given the relatively positive Omicron news that symptoms are generally milder. Flows were positive, both for ETFs and managed accounts with €364m coming in, almost making up for the net outflows experienced in December. The primary market was off to a slow start with just one deal (VodafoneZiggo's €750m senior secured sustainability-linked bond offering.) This is likely to pick up pace in the coming weeks given the expected calendar being discussed.

In reviewing 2021, the default picture ended the year with one more default, gaming company, Loewen Play, in December. This brought the number to six defaulted issuers over €3.5bn, and a 2021 default rate of 0.9%, a historical low. Given the company's bonds traded at around 90, it was also another example of the high recovery rate, characteristic of 2020 and 2021. Overall, recoveries in 2021 averaged 84%, way over the historical 40%. This trend is expected to continue given the default outlook for 2022 is sub 1%.

Issuance also hit a record level in 2021 as the year closed at €150bn, 45% higher than the record set in 2020. This was even as Q4 exhibited relatively lower issuance compared to the last quarters of 2019 and 2020. This year could be lower or not given all the M&A talk. The year has already started with talk of deals carried over from 2021 (eg, Playtech by Aristocrat, Cambiboc acquisition of Evergreen Asia, Telecom Italian LBO, Atlantia bid for Yunex).

On the ESG front, the aforementioned VodafoneZiggo new issuance set a new precedence as it included a feature where the redemption price can step down if the company hits its stability targets. This feature already exists in the loan market but had yet to appear in the bond market.

Structured credit

The US Agency MBS market posted a 1.13% loss last week as interest rates sold off on the release of hawkish Fed minutes. Mortgages widened as the market digested reduced demand and the potential for balance sheet normalisation following the first hike in interest rates. Prepayment speeds in December came in slower than November and as rates march higher, are expected to continue to slow, which will aid in the supply/demand equation in 2022.

In Non-agency MBS, gross new issuance in 2021 hit a post GFC high of $198bn. Prime 2.0 led the way followed by Non-QM and Investor owned. Delinquencies were down substantially in 2021: Prime 2.0 was down 70% and CRT and Non-QM were down 61% and 60%, respectively.

Prepayment speeds slowed Prime but picked up in Non-QM and RPL on improved credit availability and related refi incentive.

Home price appreciation continued its slowing trend off peak levels of 20% y/y in August coming in at 19% y/y in the most recent print. Demand continues to exert pressure, however, as supply of existing homes declined 11% y/y.

Asian credit

The distress in the Chinese high yield property sector remains elevated. China Credit Trust said that an entity related to Shimao Group has defaulted on a CNY792m trust product (unpaid balance CNY645m). Shanghai Shimao Construction Group (63.9%-owned subsidiary of Shimao Group) is the guarantor for its 30%-owned entity, Shanghai Qianyi Construction Materials Company, which defaulted on the trust product. According to China Credit Trust, it had only received CNY147m ($23m) of the CNY792m that was due on 27 December 2021.

Shanghai Shimao Construction stated that the default on the trust product will not trigger other early bond repayments. In order to enhance its liquidity position, similar to Powerlong Real Estate's recent $135m tap on existing notes, CIFI Holdings issued an additional $150m notes, which will be consolidated with the $350m 4.45% '26s notes it issued in May 2021.

Emerging markets

It was a weak start for the year as EMD was weighed down by both US Fed policy tightening direction and more negative news from the Chinese property slowdown.

Hard currency sovereign and corporate debt experienced negative performance both from spread widening and rising US treasury yields. EM local bonds also returned negative performance, due to both US dollar strengthening and rising yields. Still, the asset class experienced inflows of $391m, the year's first week, mainly ETF-driven as managed accounts saw very small outflows. This was specifically the case for hard currencies breaking a seven-week streak of outflows. It was different for local currency funds as they continued December's trend of outflows, with only Chinese funds differing as they are still experiencing inflows.

EM central banks continue the rate hiking trend of 2021, given rising inflation concerns, with Poland being the first central bank to hike in 2022 as it raised rates 50bps to 2.25%, indicating there is still room for another hike. The central bank of Peru followed suit, later in the week, as it also raised rates 50bps to 3.0%, while saying that more increases are likely.

In Russian news: much higher energy prices was the trigger point in Kazakhstan as anti-government demonstrations took over the country, protesting ostensibly about higher petrol prices but really due to general dissatisfaction with the state. In response, Putin sent Russian troops to help Kazakh forces secure the country and restore control. Alongside this action, regarding Ukraine, Putin has started to amass troops at the Russia-Ukraine borders (north, south, and east) making demands that NATO pull back from increasing ties with Ukraine and setting off a potential stand-off with the West. This is being called the largest military actions in Europe since WWII.

In government support news, Sri Lanka announced a $1.1bn relief package (cash allowance to public sector, agriculture subsidies, removal of taxes on essential goods and drugs).

Commodities

A strong start for the year with the index up 2.1%.

This was largely led by energy, especially oil, as crude oil was up around 5% and oil products were up 6% and higher. OPEC continues to hold the position to not increase production in January. Oil prices were also supported by news that Chevron had closed some production sites in Kazakhstan on back of the anti-government unrest. Natural gas, in Europe, rose sharply on lack of Russian flows as well as due to Russian troops in Kazakhstan and at the Ukrainian borders, and even dragged up higher US natural gas at one point, last week. Tightness of energy is also a risk on the upside for most of the base metals due to the need for production.

Base metals were also higher, largely due to aluminium, which was up almost 4%, as copper and nickel performed negatively for the first week of 2022. Precious metals were down for the week, on the back of the Fed's hawkish indications, led by silver that fell 4% while gold was down almost 2%.

Agriculture was also stronger on the back of weather concerns in South America, especially Brazil and Argentina, mainly effecting soyabeans as wheat posted a negative return for the week. Expectations for 2022 are strong, even after the 27% return for 2021.

Responsible investments

The European Central Bank is front and centre this week for the responsible investments view on the credit market. Executive Board member Isabel Schnabel made a speech over the weekend making it clear that inflation forecasts may need to remain higher for longer as the EU attempts to be the world's first carbon-neutral region by 2050. She remarked that: "In an environment of large excess savings and protracted supply disruptions, the energy transition may lead to inflation remaining higher for longer, thereby potentially raising the risks of inflation expectations destabilising." Inflation for December surprised the market on Friday at 5%, but the latest forecasts show inflation reaching 3.2% this year and then slowing to 1.8% for 2023 and 2024. Schnabel noted in her speech that these forecasts included technical assumptions on energy components that were "surrounded by significant uncertainty".

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

10th January 2022

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. ▪ We are past the peak of economic growth and central bank accommodation. The pullback in forecasted liquidity has left opportunity for market volatility. ▪ 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. ▪ Downside risks: Omicron worsens. Supply chain disruptions and inflation fears continue into 2022. Both fiscal and monetary stimulus are removed just as growth decelerates could cause a sell off
Duration (10-year) ('P' = Periphery)	Short -2 -1 0 +1 +2 Long Above: ¥ (0); P, $ (+1) Below: £, € (+1)	▪ Carry offered by front end yields now attractive ▪ Longer yields continue to be capped by long-run structural downtrends in real yields ▪ Inflation likely to normalize over medium term ▪ Hiking cycles to be shortened by easing inflation and moderating demand ▪ ECB to lean against rising financing rates	▪ Inflationary dynamics become structurally persistent ▪ Labour supply shortage persists; wage pressure becomes broad and sustained ▪ Fiscal expansion requires wider term premium ▪ Long run trend in safe asset demand reverses
Currency ('E' = European Economic Area)	Short -2 -1 0 +1 +2 Long Above: £ (-1); ¥, EM (0) Below: E (-1); A$ (0); $ (+1)	▪ 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 ▪ Tactically reduced EURUSD short given the uncertainty around Omicron and potential impact on Fed tightening cycle.	▪ Re-acceleration of global growth forecasts led by reversal of China credit contraction ▪ US fiscal push fades ▪ Omicron variant requires reimposition of health measures and knocks Fed off course, to the benefit of low yielding majors versus the Dollar.
Emerging Markets Local (rates (R) and currency (C))	Under-weight -2 -1 0 +1 +2 Over-weight Above: R (0) Below: C (0)	▪ Selective opportunities ▪ 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 ▪ Tightening global financing conditions
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 ■0 +1 +2 Over-weight	▪ Valuations are getting increasingly more attractive ▪ 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).	▪ Spillover from China's credit woes ▪ 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 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 ▪ Bank loans continue to be a more attractive part of the show better valuations relative to corporates. ▪ 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, although mounting negative headwinds (inflation, supply disruptions) are increasing pressure for higher yields. ▪ 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's taper was well advertised and saw a muted market reaction upon official announcement. ▪ Valuations remain extremely rich, with unattractive carry in many Specifies Pools and CMO deals ▪ 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. ▪ 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 in this area. ▪ Opportunities with repricing risk premiums in new issues ▪ 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.	▪ Attractive shorter duration deals coming into market, provide less carry ▪ 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 Oil ▪ o/w Natural Gas	▪ US China trade war ▪ Renewed Covid lockdowns ▪ Global Recession

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