INFORMATION FOR INVESTMENT PROFESSIONALS

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In Credit

14 JUNE 2021

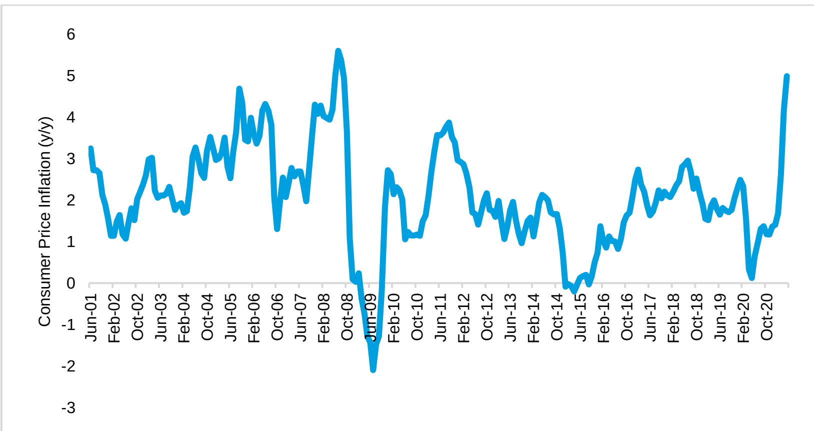
'It's inflation Jim, but not as we know it'.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.46%	-9 bps	0.7%	-2.8%
German Bund 10 year	-0.27%	-6 bps	0.6%	-2.6%
UK Gilt 10 year	0.71%	-8 bps	0.7%	-5.9%
Japan 10 year	0.04%	-5 bps	0.3%	0.1%
Global Investment Grade	91 bps	-2 bps	0.9%	-1.3%
Euro Investment Grade	84 bps	-1 bps	0.5%	-0.3%
US Investment Grade	90 bps	-1 bps	1.0%	-1.7%
UK Investment Grade	91 bps	-1 bps	0.6%	-2.6%
Asia Investment Grade	211 bps	4 bps	0.8%	-0.7%
Euro High Yield	297 bps	-7 bps	0.7%	3.1%
US High Yield	321 bps	-7 bps	0.8%	3.1%
Asia High Yield	577 bps	19 bps	-0.8%	1.0%
EM Sovereign	304 bps	-4 bps	1.3%	-0.6%
EM Local	4.9%	0 bps	0.8%	-1.4%
EM Corporate	298 bps	1 bps	0.6%	1.1%
Bloomberg Barclays US Munis	0.9%	-8 bps	0.7%	1.5%
Taxable Munis	2.2%	-9 bps	1.5%	-0.4%
Bloomberg Barclays US MBS	25 bps	6 bps	0.1%	-0.6%
Bloomberg Commodity Index	200.49	0.3%	2.3%	21.7%
EUR	1.2114	-0.5%	-1.0%	-0.9%
JPY	109.76	-0.1%	-0.1%	-5.8%
GBP	1.4104	-0.4%	-0.7%	3.2%

Source: Bloomberg, Merrill Lynch, as at 11 June 2021.

Chart of the week: US Consumer Price Inflation (y/y), 2001-2021



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

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Macro / government bonds

Quarter one of this year was a miserable experience for the bond market. There was just too much 'good news' flowing around the system to contain bond yields. The Biden fiscal push, the successful rollout of Covid-19 vaccines and, of course, an economic rebound fuelled fears of inflation that were further fanned by supply shortages as economies reopened. US yields at the 10-year point ended March over 80bps higher than the end of 2020.

So it is with fingers crossed that the second quarter looks to be a far more constructive period for core bond markets. US yields are now close to the lowest level since the end of Q1, 2021 and inflation concerns have withered at least somewhat; with breakeven inflation rates now a good way off the recent highs reached in mid May. Inflation of course is the 'issue du jour' in markets and so with this in mind the consumer price inflation release was the key economic event of last week. It came in the wake of an outsized report in April (4.1% y/y). May saw consumer prices rise by a further 0.6% taking the annual rate to 5.0%. Meanwhile, the core reading came in at 0.7% m/m or 3.8% y/y. As much of this 'bad news' had already been priced in yields did not rise on the news. The US Federal Reserve has noted that it expects inflation to rise in the shorter term, but for this to be a transitory phenomenon.

Longer term, we believe inflation will remain contained by the forces of globalisation, technology, demographics and deunionisation.

Investment grade credit

We can get index data (from ICE BofAML) going back to late 1996. The average range of spreads in any three month period in those years has been around 25bps. The maximum was between August-November 2008 at around 225bps (Global Financial Crisis) whereas the lowest was only 1bps in the first quarter of 2006. Today conditions are certainly more like 2006 than 2008; indeed, should spreads end this month at 91bps then the spread variation would be around 7bps. In other words volatility is currently very low indeed in credit markets.

The direction of spreads is, as always, caught between positive and negative forces. In the fomer camp lie improving credit fundamentals (witness the recent reporting season and our analysts' forward-looking projections); accomodative (present and forward-looking) policy conditions; and a more resilient economic background. However, bond valuations have come a long way to reflect this reality. Indeed, in the context of short and longer-term averages, spreads are between 0.7 and 1.2 standard deviations expensive.

High yield credit

US high yield bond prices increased over the week alongside the steep decline in US treasury yields. The ICE BofA US HY CP Constrained Index returned 0.48% over the week while spreads were 8bps tighter, ending the week at +329bps (only 4bps wide of the post-financial crisis tights). Meanwhile, the yield-to-worst of 3.88% was 0.13% lower w/w, matching its all-time low. The asset class reported its 6th consecutive weekly outflow with a $642m withdrawal.

European high yield experienced another week of strength, continuing the theme of the last three weeks. Spreads broke through the 300bps level, reaching 297 while the yield to worst fell to 2.5%. Flows were higher with €145m coming into the asset class across ETFs and managed accounts. It was a heavy primary week with €4.7bn among seven new issues; the new bonds were mostly well received, generally tightening in from initial price talk followed by prices trading higher in the secondary market.

It is interesting to note that the European high yield market size has increased by 50% since the end of 2019 with a current size of €475bn as compared to €320bn. While 2020 was largely due to 'Fallen Angels', this year has been more due to new issuers coming to the market with 'Rising Stars' starting to be a consideration.

In issuer specific news, Altice announced it had taken a 12% stake (valuation at £2.2 bn) in BT but made clear that there aren't any plans to make a takeover offer. There are already questions how this stake acquisition will be funded as the Altice made clear that shares of any of the Altice entities will not be pledged as part of the transaction.

Leveraged loans

The yield and spread (3-year) on the J.P. Morgan Leveraged Loan Index declined 7bps and 3bps over the week to 4.63% and 425bps, respectively. As with high yield bonds, this is a record low yield for the asset class. The loan index has returned 0.25% month-to-date with Split B/CCC loans (+0.72%) outperforming B (+0.23%) and BB loans (+0.14%). Loans are underperforming high yield bonds by 45bps during June's rate decline after outperforming by 25bps in May. Despite lower interest rates, the asset class experienced its 22nd consecutive weekly inflow with $925m of retail fund contributions over the week.

Asian credit

The Biden Administration has signed a new Executive Order 14034 (EO14034), which revoked the prohibitions on Tiktok and WeChat that were initiated during the Trump Administration. The EO14034, however, will institute a new framework to assess the national security risks of transactions on apps that are linked to governments or militaries of foreign adversaries such as China, or apps that collect sensitive data from US consumers.

Moody's downgraded Delhi International Airport's (DIAL) corporate family rating and senior secured ratings from Ba3 to B1 with a 'negative' outlook. The downgrade is driven by the reduced passenger traffic and airport revenue in FYE March 2022 following the surge in Covid-19 cases since late March. Moody's expects DIAL to take additional debt to complete the expansion of the airport.

The Financial Stability and Development Committee in China has reportedly communicated to the domestic banks to assess their exposure to China Evergrande Group. This follows the reports that the regulators are likely to scrutinise Evergrande's business dealing with Shengjing Bank. Evergrande holds a majority stake in Shengjing Bank. Evergrande, however, denied that the regulator is pushing banks to stress test their exposure to the company. It also stated that it would repay a small amount of overdue commercial paper and that its dealings with Shengjing Bank are compliant with the law. China is reportedly considering to impose a cap on the price of thermal coal in response to high energy costs, which will rise further due to summer energy demand. One of the proposals is the enforcement of a price limit (CNY930/tonne) for the benchmark coal at the Qinghuangdao port. China's previous measures on controlling coal prices have not been successful. Travel between Macau and Mainland China has been tightened further following the rise in Covid-19 cases on Guangdong Province. Travellers from the Guangdong Province must produce a negative Covid test results issued within the 48 hours (previous: 7 days) while those coming from certain districts must undergone 14-day quarantine.

Structured credit

The US Agency MBS market posted a positive return of 9bps last week, lagging its high-quality corporate peers. As rates bull flattened with 10-year US treasuries breaking through their March 1.5% lows, expectations for prepay speeds picked-up and lower coupon mortgages widened as they are generally more rate sensitive. Origination should also be picking up so supply in June will likely be higher and met with lower purchases by the Fed of roughly $10bn less this month vs last month (that is gross purchases while net $40bn a month remains fixed for now).

In CMBS, secondary supply was above average with levels grinding tighter across the stack. Cash bonds outperformed CMBX. Relative value, positive technicals and improving fundamentals continue to support the CMBS market overall. Many of the same themes apply to non-agency RMBS with continued acceleration in home price appreciation given low supply.

Emerging markets

South Africa exceeded GDP growth expectations, growing 4.6% in Q1, beating the expected 3.1%. In Angola, the IMF approved a disbursement of $772m following the country's strong fiscal adjustment in 2020.

In Covid news, Guangdong province, China's manufacturing hub, has seen a rise in Covid cases resulting in the government stepping up mass testing as a result. Elsewhere, Malaysia has extended its lockdown by two weeks.

In other news, President Biden revoked the Trump administration's ban on Chinese apps such as TikTok and WeChat. This follows an executive order banning US investment in 59 Chinese companies including Huawei. This takes the total number of banned companies to 66, with a combined market cap of $595bn.

On the issuance front, Oman came to the market with a $1.75bn 9-year sukuk. The issue is set to finance the government's reform agenda following last month's protests for job creation.

Commodities

Energy markets marched higher, led by natural gas (+6.3%) and WTI (+1.5%). Hotter weather forecasts in the US are expected to raise air conditioning demand and thus demand for natural gas. WTI rallied on the back of further demand recovery. In its latest report the IEA expect global oil demand to reach pre-pandemic levels by mid-2022.

In Agriculture, soybeans (-2.8%) and soybean oil fell in tandem (-4.4%), following reports that the Biden administration is considering ways to relieve US oil refiners from biofuel blending mandates. US refiners are currently required to blend biofuels into their fuel supply, which has led to enhanced demand as refiners have been ramping up plans to make renewable fuels. As a result, corn and soybeans have experienced excess demand with soybean oil prices rising 69.5% year-to-date.

Responsible investments

This week, the Bank of England released the scenarios for its climate risk stress for UK banks and insurers. The results won't be announced till next May and this round of testing will be a "learning exercise". Longer term, climate risk stress tests will be a integral part of the regulatory toolkit and could serve as the mechanism through which higher capital charges are attached to loans to polluters.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

14th June 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 with better liquidity than before 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, & central bank reaction functions do increase uncertainty.	■ 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 and Russia or China
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	■ 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	■ Political risk is rising at the same time as the pandemic is surging in many large EM's. There are several Latam elections this year with a wide array of possible outcomes, and worsening COVID and low growth is central to them. ■ 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. ■ There are even further delays in mass vaccination outside of developed markets.
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. ■ These unattractive technicals may persist if the Fed continues buying. Fed buying cannot be expected to increase in 2021, ultimately 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	■ 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: favoured bonds are still 'story' bonds. A return to normal won't look 'normal' for sectors like office space or convention hotels ■ 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 ■ o/w Soybeans ■ u/w Livestock ■ u/w Gold	■ US China trade war