COLUMBIA THREADNEEDLE INVESTMENTS

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# In Credit

21 JUNE 2021

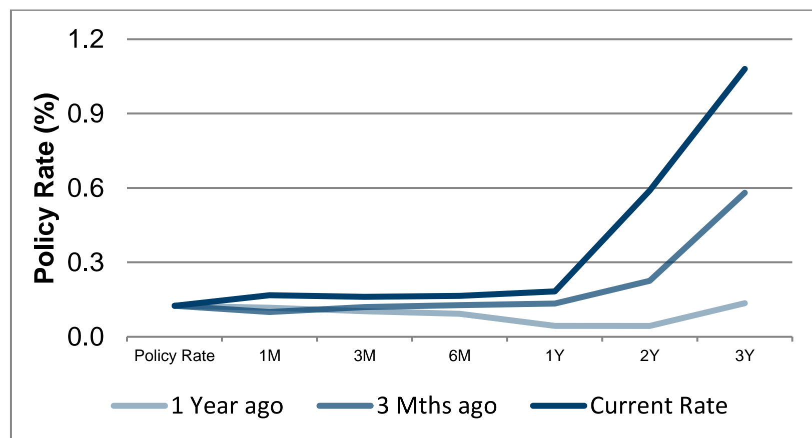
## A flatter Earth!

### Markets at a glance

| | Price / Yield / Spread | Change 1 week | Index MTD return | Index YTD return |
|---|---|---|---|---|
| US Treasury 10 year | 1.44% | -2 bps | 0.9% | -2.6% |
| German Bund 10 year | -0.20% | 8 bps | 0.7% | -2.6% |
| UK Gilt 10 year | 0.75% | 4 bps | 0.9% | -5.7% |
| Japan 10 year | 0.05% | 2 bps | 0.1% | -0.1% |
| Global Investment Grade | 89 bps | -2 bps | 1.2% | -1.0% |
| Euro Investment Grade | 84 bps | 0 bps | 0.4% | -0.4% |
| US Investment Grade | 87 bps | -3 bps | 1.6% | -1.1% |
| UK Investment Grade | 90 bps | -1 bps | 0.6% | -2.7% |
| Asia Investment Grade | 202 bps | -10 bps | 0.7% | -0.7% |
| Euro High Yield | 301 bps | 4 bps | 0.7% | 3.0% |
| US High Yield | 318 bps | -3 bps | 0.7% | 3.0% |
| Asia High Yield | 565 bps | -12 bps | -0.6% | 1.2% |
| EM Sovereign | 311 bps | 7 bps | 1.0% | -0.9% |
| EM Local | 5.0% | 9 bps | -1.7% | -3.8% |
| EM Corporate | 292 bps | -6 bps | 0.7% | 1.1% |
| Bloomberg Barclays US Munis | 1.0% | 8 bps | 0.3% | 1.1% |
| Taxable Munis | 2.2% | -2 bps | 2.5% | 0.6% |
| Bloomberg Barclays US MBS | 31 bps | 6 bps | -0.2% | -1.0% |
| Bloomberg Commodity Index | 192.99 | -4.3% | -2.0% | 16.5% |
| EUR | 1.1892 | -2.0% | -3.0% | -2.9% |
| JPY | 110.11 | -0.5% | -0.6% | -6.3% |
| GBP | 1.3883 | -2.1% | -2.8% | 1.0% |

Source: Bloomberg, Merrill Lynch, as at 19 June 2021.

### Chart of the week: The change in US interest rate expectations.




Source: Bloomberg, Columbia Threadneedle Investments, as at 17 June 2021.

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## Macro / government bonds

Today is the 21 June – the summer Solstice. From here on out, in the Northern Hemisphere, days will get shorter. You have been warned!

Last week, the US Federal Reserve's updated forecasts indicated a pronounced (but still transitory) rise in inflation this year (Core PCE expected to end 2021 at 3.0% revised from a 2.2% expectation in March). The Fed suggested rates will need to rise in 2023 with a heightened risk of something sooner, and acknowledged it is talking about tapering its asset purchases. The market's views about implied rates and changes in those expectations are reflected in **chart of the week** for comparison.

Our view is that this suggests the Fed seems less content to let the economy and inflation 'run hot' and supports the idea of an ongoing flattening of the yield curve as we go forward. It is also possible (indeed likely) that the central bank will use the Jackson Hole conference in August to give a clearer message about the timing of tapering, probably to begin around the year end, assuming everything goes to plan. Yields initially rose, before declining meaningfully and especially at the long end of the curve. The 30-year yield fell to the lowest level since February of this year and below 2%. It was 'harder going' for shorter-dated bonds with the five-year yield rising by around 10bps. Meanwhile, inflation expectations that have been rising in the last year have declined from c2.55% in mid-May to c2.25% at the 10-year point of the curve. The US dollar also rallied on the news. There was little data to distract attention from the Fed. US Producer Prices rose to 6.6% y/y, which was above the expected rate.

For other markets there was a more 'damped' response - with neither the size of initial sell nor the extent of the subsequent rally. This week brings flash PMI data (globally) and inflation data (US). The Bank of England meets with no change in policy expected.

## Investment grade credit

It may have been 'A Midsummer Night's Dream' for long-term government bonds but it was more 'Much Ado About Nothing' for their credit cousins.

For credit markets, policy conditions (as described) will remain supportive for spreads if the Fed's forecasts play out in the next couple of years. It will be when monetray policy starts to become tight that we will have more concerns with respect to this factor. Nothing to worry about yet, as it were, though the direction of travel is changing very slowly.

In specific news, Morrison's (the UK supermarket) rejected a bid from a US private equity fund. Bonds were significantly wider on speculation of further private equity interest. In the same sector, Tesco reported solid numbers at the end of the week. New issuance remains down versus last year in both euros and US dollars.

## High yield credit

US high yield bond prices were modestly lower over the week alongside equity weakness, continued outflows and US treasury volatility. The ICE BofA US HY CP Constrained Index returned -0.11% over the week. Spreads were 3bps tighter, ending at +329bps and the YTW of the index increased 0.09% to 3.97%. According to Lipper, the asset class reported a $2.2bn outflow. This was the seventh consecutive outflow for US high yield, leaving the YTD outflow at nearly $15bn.

European high yield had a consolidation week post the FOMC meeting and given some market indigestion post the recent heavy primary weeks with spreads widening 4bps. Inflows into the asset class continued to rise with €260m last week, almost equally split between ETFs and managed funds. New issuance amounted to €5.7bn in names including TVO (Finnish utility), Punch (UK pubs), Nomad Foods (frozen foods) last week with most initially well received, though there was some price retracement by the end of the week. It should be noted that more of the new issuance is being driven by M&A news and new issuers coming to the market.

The default outlook for the asset class continues to improve with the previous 2021 forecast of 2.0% falling to 1.25% (JPMorgan), with a 1.0% outlook for 2022. The high recovery rate (54% in 2020) also looks to continue, meaning lower credit losses that makes credit spreads, even at these lower levels, looking fair. Key to this is European Central Bank action which, for the moment, remains steady on course to continue to be market supportive.

In sector and issuer specific news, European car sales were up 74% (34% YTD). On the leisure sector front, Carnival had positive news with talk of reopening cruises from September onward for passengers with two Covid-19 jabs.

## Leveraged loans

Leveraged loans were not immune to the volatility and saw the first price decline in the last five weeks, albeit only slightly. The average price of the J.P. Morgan Leveraged Loan index declined $0.03 to $98.60. The average price for BB loans decreased $0.06 to $99.42, Single Bs fell $0.03 to $99.40 and Split B/CCCs decreased $0.04 to $91.30. That said, prices for the index are still $0.36 higher over the last month. Loans are underperforming high yield bonds by 40bps during June's rate decline after outperforming by 25bps in May. The asset class saw its 23rd consecutive weekly inflow with a $559m subscription over the week.

## Asian credit

Last week, the Economic Times (India newspaper) stated that the Demat account of three foreign funds (Albula Investment Fund, Cresta Fund and APMS Investment Fund), which holds shares in several Adani companies, remained frozen due to insufficient disclosure of beneficial ownership of these foreign funds. The Demat Account refers to the electronic account at the National Securities Depository Limit (NSDL) of India. These three funds hold shares in several Adani Group companies (Adani Enterprises, Adani Transmission, Adani Total Gas and Adani Green). The funds do not hold stakes in Adani Ports and Adani Power. The report also mentioned that SEBI (Securities and Exchange Board of India) is investigating the possibility of price manipulation in the share prices of Adani companies, which have rallied significantly YTD. The shares have relatively low free float and the promoter group (Adani family) holds substantial stakes in the Adani companies. The Adani management has rebutted the report as inaccurate and provided confirmation from the NSLD that the accounts are not frozen.

Moody's has revised SK Hynix's Baa2 issuer and senior unsecured ratings to review for downgrade due to the parent company, SK Telecom's plans to spin off its non-telecom investments, including its 20% stake in SK Hynix. SK Telecom plans to create a new company called SKT Investments Co by November 2021. Moody's views that the new parent company will have lower ability than SK Telecom in providing extraordinary support to SK Hynix.

## Structured credit

The Agency MBS market posted a 34bps loss last week underperforming other high-quality sectors in post-FOMC trading. The Fed is now talking about tapering and the June dot plot raised concern of a 'sooner rather than later' taper at a potentially quicker pace. In terms of demand for the sector, overseas investors net increased agency MBS holdings more recently and Japan has been the outsized buyer. China also net added agency bonds. GSE forbearance rates continue to improve and are now down to 2.3%. In non-agency RMBS, it was a quiet week. Volumes remain healthy as rates steadily compress. Fundamentals continue to heal as the economy re-opens with reduced delinquencies across Non-QM, RPL, Prime Jumbo and CRT. Prepayment speeds stand at or near more recent highs which keeps reinvestment needs elevated. In CMBS, June remits across 319 deals evidenced 53 newly delinquent 2.0 loans. The DQ rate overall is tracking slightly higher than last month while investors suffered de-minimis losses on recently liquidated properties.

## Emerging markets

In central bank news, Brazil hiked rates 75bps to 4.25% in response to inflation pressures driven by rising electricity costs. In Indonesia, rates were held at record lows of 3.5% as inflation remains below target. The decision was influenced by the US Federal Reserve's hawkish shift as the central bank seeks IDR stability. In Turkey, rates were held steady at 19%. Tight policy is to be maintained until a significant fall in inflation materialises approaching the 5% target. In China, retail sales (+12.4%), industrial production (+8.8%) and fixed asset investment (+15.4%) all missed expectations in May. China is also seeing high unemployment in the 16-24 age demographic at 13.8%, whilst the overall figure stands at 5%. In corporate news, Gazprom has taken responsibility for an 1830 metric ton methane leak (equivalent to 40,000 US cars driving for a year). This marks the largest release in the oil and gas sector since September 2019.

## Commodities

The commodity index was in retreat last week (-4.3%) following hawkish comments from the US Fed. Commodity markets have been a key beneficiary of the global demand recovery particularly within industrial metals. Energy markets were more resilient (-0.2%) given continued strong global demand; China's demand for oil currently exceeds 2019 levels. Base metals fell 6.3%, with copper prices dropping the most (-8.4%). Base metals were hit by the prospect of a cooling global recovery and China's state metal stockpiles being released into the market. China has been a critic of high commodity prices in recent months and is taking direct action as a result. Agriculture markets fell 7% on a combination of more favourable weather conditions within the US corn belt and the earlier mentioned prospect of US refineries being given relief from biofuel blending mandates. In precious metals, gold and silver declined 5.9% and 7.7% respectively. A higher US growth outlook and higher expected US interest rates made non-interest-bearing safe heaven assets less attractive.

## Responsible Investments

We refreshed our Investment Grade Credit 'Greenium' model last week. There are now around 249 Green, Social or Sustainable bonds in the euro investment grade universe. That means they now occupy a footprint of around 8% of the index. We estimate that the average bond has a premium of 1bp to an issuer's credit curve; this has not changed meaningfully since the start of the year. However, the average auto sector Green bond trade is around 15bps rich to ordinary conventional bonds of the same issuer.

# Summary of fixed income asset allocation views

## Fixed Income Asset Allocation Views

21st June 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 | ▪ Growth is robust as we emerge from the worst of the COVID experience, nowhere more than in the US. Credit fundamentals across sectors are improving rapidly. In fact, the demand turnaround is so severe in some areas that supply constraints are throttling further growth.<br>▪ Spreads are near all-time tights and leave little room for the growth story to get derailed, but pockets of opportunity with deleveraging & upgrade activity exist.<br>▪ We are past the peak of central bank accommodation. The pullback in liquidity won't be aggressive, but it leaves opportunity for market volatility. | ▪ 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: 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)**<br>('P' = Periphery) | P<br>¥ $<br>Short -2 -1 0 +1 +2 Long<br>£<br>€ | ▪ Rangebound government bond market likely, with bias to lower yields<br>▪ Pandemic scarring keeps reflation credibility low<br>▪ Fed QE and high personal savings underpin demand for treasuries<br>▪ ECB likely to lean against rising financing rates<br>▪ Duration remains best hedge for further risk asset correction | ▪ Permanent fiscal policy shift rebuilds reflationary credibility and raises r*<br>▪ Fiscal largesse steepens curves on issuance expectations<br>▪ Consumption rebound stimulates long-term inflation expectations<br>▪ Risk hedge properties deteriorate |
| **Currency**<br>('E' = European Economic Area) | ¥<br>£ EM<br>Short -2 -1 0 +1 +2 Long<br>E A$ $ | ▪ US growth outperformance on back of fiscal stimulus boosts USD<br>▪ ECB increasingly sensitive to Euro appreciation | ▪ Vaccine rollout in Europe improves and narrows growth gap<br>▪ US fiscal push fades |
| **Emerging Markets Local (rates (R) and currency (C) )** | R<br>Under-weight -2 -1 0 +1 +2 Over-weight<br>C | ▪ Favourable advanced economy policy settings support EM assets in near term<br>▪ EM real interest rates relatively attractive, curves steep | ▪ Sharp escalation in global risk aversion, leading to higher EM inflation via fx<br>▪ 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.<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).<br>▪ 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<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 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.<br>▪ Balance sheets weathered 2020 well, and are deleveraging due to responsibly capital management and good sales growth.<br>▪ 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.<br>▪ 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<br>▪ The best performing parts of these sectors have been the most volatile and lowest quality.<br>▪ 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.<br>▪ Waves of ratings upgrade begin to occur 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 | ▪ The Fed buying has overwhelmed highly negative fundamentals, as seen by the near-zero spreads in bonds the Fed buys and poor performance elsewhere.<br>▪ 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.<br>▪ 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.<br>▪ 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.<br>▪ 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.<br>▪ CMBS: favoured bonds are still 'story' bonds. A return to normal won't look 'normal' for sectors like office space or convention hotels<br>▪ Spread tightening looks somewhat excessive along the margins of credit quality. | ▪ Changes in consumer behaviour in travel and retail last post-pandemic.<br>▪ Work From Home continues full-steam-ahead post-pandemic (positive for RMBS, negative for CMBS).<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>▪ o/w Grains<br>▪ u/w Livestock<br>▪ u/w Gold | ▪ US China trade war |

**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 21.06.2021, unless otherwise stated.

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