COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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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
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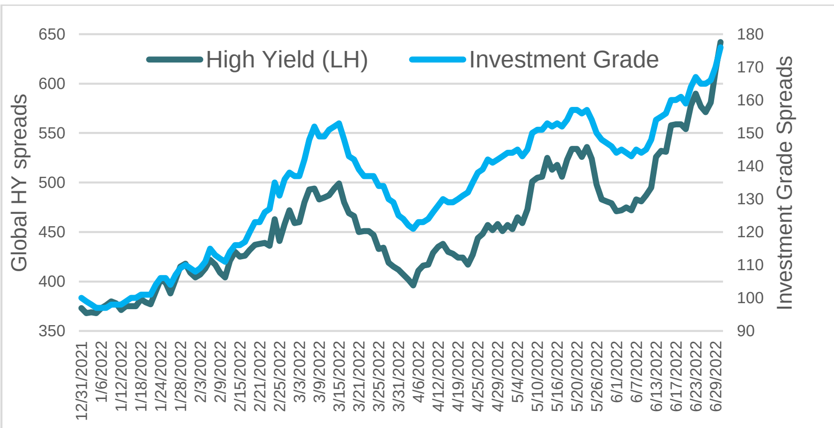
Declaration of Interdependence.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	2.88%	-25 bps	0.3%	-8.9%
German Bund 10 year	1.27%	-17 bps	0.9%	-10.4%
UK Gilt 10 year	2.13%	-17 bps	1.8%	-13.2%
Japan 10 year	0.23%	0 bps	0.2%	-2.8%
Global Investment Grade	177 bps	12 bps	0.4%	-12.7%
Euro Investment Grade	212 bps	16 bps	0.8%	-11.5%
US Investment Grade	165 bps	10 bps	0.2%	-13.7%
UK Investment Grade	164 bps	8 bps	1.1%	-11.5%
Asia Investment Grade	234 bps	4 bps	0.2%	-8.0%
Euro High Yield	675 bps	78 bps	0.1%	-15.0%
US High Yield	592 bps	74 bps	0.2%	-13.9%
Asia High Yield	886 bps	-10 bps	0.0%	-19.2%
EM Sovereign	458 bps	28 bps	0.9%	-18.1%
EM Local	7.0%	-2 bps	-0.3%	-14.8%
EM Corporate	415 bps	30 bps	0.2%	-13.8%
Bloomberg Barclays US Munis	3.2%	-9 bps	0.4%	-8.7%
Taxable Munis	4.2%	-21 bps	0.8%	-15.5%
Bloomberg Barclays US MBS	44 bps	-5 bps	0.8%	-8.1%
Bloomberg Commodity Index	251.04	-3.4%	0.1%	18.5%
EUR	1.0427	-1.3%	-0.7%	-8.4%
JPY	135.28	0.0%	0.4%	-14.9%
GBP	1.2110	-1.4%	-0.7%	-10.6%

Source: Bloomberg, Merrill Lynch, as at 4 July 2022.

Chart of the week: Global credit spreads – YTD 2022



Source: ICE indices, Bloomberg, Columbia Threadneedle Investments, as at 30 June 2022.

Macro / government bonds

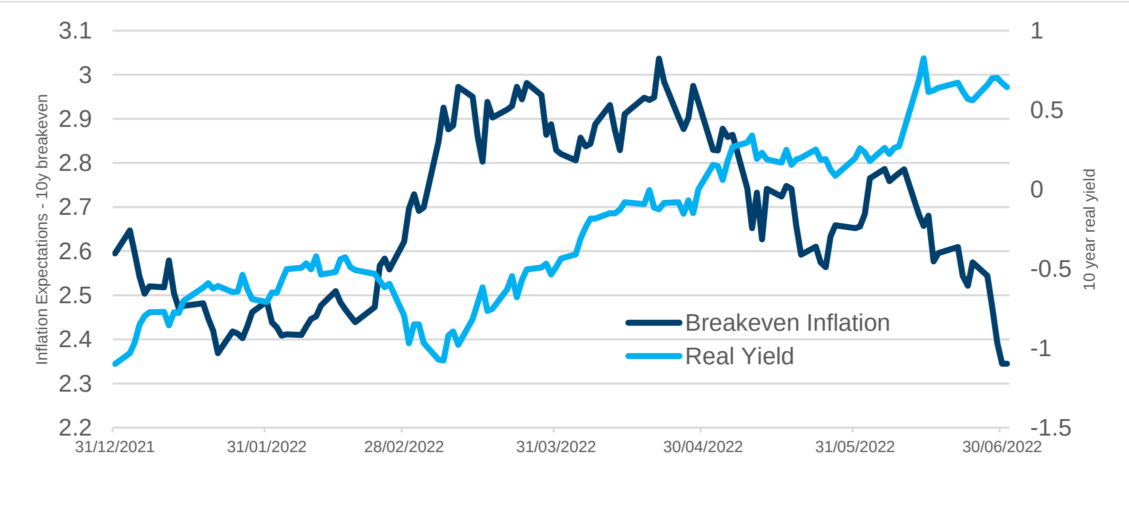
We have reached the mid-point in this year of financial market collapse.
Equity markets have spiralled lower and credit market spreads gapped wider, but the traditional role played in portfolios of core government bonds has been more than lacking. Indeed, aside the last week or two yields have continued higher though the second quarter. In our view, this makes some sense this time. Markets were buffeted by rising inflation and expectations from March of 2020 through to late spring of this year. Since then, expectations have fallen on a 10-year basis from over 3% to under 2.5% in the US market. What hasn't fallen has been real yields. As central banks raise rates and dismantle balance sheets this discount rate has risen massively. The real yield on US inflation protected bonds has gone up from less than -1% to around 0.7% in the space of six months. How does that real yield compare to long term averages? Not that well really. Since their introduction in 1996 the average real yield has been around 1.5% . So more to go if you believe in mean reversion **(see second chart of the week).**

A theme that has developed this quarter has been this shift from inflation worries to recession concerns, but it is a widely anticipated anxiety. In a survey conducted by Deutsche Bank it appears around 90% of respondents expect a recession within the next 18 months. This is up from around one in three at the end of last year.

There was no shortage of poor data to underpin this pessimism last week. Consumer sentiment data came in at a record low in Germany and was the weakest since 2013 in France. Meanwhile, US jobless claims rose on a four-week average basis to the highest this year while unemployment also rose in Germany.

On the inflation front there were mixed messages in Europe: Spanish prices rose by 10% y/y, which was well ahead of the 8.7% forecast. However, data from Germany was weaker led lower by tax breaks to 8.2%, which was around 0.5% less than expected. On the manufacturing side, the Dallas Federal Reserve noted that confidence reached a two-year low. As mentioned last week this 'bad news' is being seen as good news for core government bond markets where yields fell again and sharply into the close of quarter and Independence Day in the US.

Second chart of the week: US 10-year inflation expectations and real yields – YTD



Source: Bloomberg, Columbia Threadneedle Investments, as at 1 July 2022.

Investment grade credit

While it was a difficult quarter for government bonds it was worse still for credit markets.

For the global investment grade area, the total return in the first three months of the year delivered a near 7% decline in local currency terms. This performance was matched in last three months with another 7% drawdown. 2022 is, as a result, easily the weakest year for total returns since index data began in 1997.

By currency area, euro-denominated credit has underperformed, and by a wide margin. This is driven by wider swap spreads but also thinner, less liquid markets in these difficult times. While US dollar market spreads are over 60% wider, the euro market has seen spreads more than double in only six months. Interestingly, euro IG has underperformed euro HY on a risk-adjusted basis, while the reverse is true in the US market.

Short-dated credit has underperformed as credit curves flatten. Notably the 1–5-year US dollar index has seen spreads widen by a similar amount to the euro market while long-dated debt in this market is only around 40% wider.

On a sector basis autos, real estate and banking have been the underperformers, while energy (rising oil price), telecoms and utilities (non-cyclical) have held up best. So cyclicality is being hurt as recession fears rise. Ratings wise, riskier credit (ie, BBBs) have underperformed while AAAs have performed best on a risk-adjusted / percentage basis.

We tend to consider a few variables in assessing the direction of credit spreads. In summary we are left on ‘the right side of okay’ on direction but that is not an emphatic view.

We know policy conditions will provide a headwind as they move from accommodative through neutral to restrictive. We also expect global growth to continue to slow, though we do not yet forecast the slowdown to become a full blown (two quarters) recession. This environment is not that bad. Low but positive growth will rein in ‘animal spirits’ in the corporate boardroom yet avoid material corporate distress / rising defaults. Our assessment of corporate fundamentals remains positive and suggests ongoing improvement.

What of valuations? Spreads on a global basis are 1.8 standard deviations (SDs) cheap to a five-year average but only 0.5 cheap on a longer-term, 20-year comparison. Indeed, if we adjust the index for the decline in credit quality and increase in duration over those two decades the number falls to only 0.2 SDs cheap. So reasonable rather than outstanding value. As mentioned, though, the euro market stands out in valuation terms and is over 3 SDs over the shorter and over 1 SD cheap compared to the longer-term average.

Lastly, heightened volatility and periods of challenged liquidity often offer an interesting entry point to the market, and this is the case currently.

High yield credit & leveraged loans

The European High Yield (EHY) market continued to be challenged, like most risk assets, last week. June finished with spreads wider by 167bps ending at 661bps (bringing Q2 spreads 210bps wider) as yields rose 190bps closing at a YTD high of 7.8%. Excluding March 2020 and its quarter, it was the worst performing month and quarter since the autumn of 2008 as the month’s return was -7.1% resulting in a Q2 return of -11% and YTD return of -14%. Fund flows continued toward the exit door, with net flows hitting -€4.5 bn for Q2 and -€8.5bn YTD (11% of the EHY universe). With the exception of short-dated BBs, the majority of the market appeared very difficult to trade, with riskier credits (single Bs and CCCs) largely only showing offer prices. In terms of sectors, cyclicals were the major underperformers. ETFs traded at a discount, as much as by 2 points. The primary market was closed last week as the 888 deal was again postponed. With only €6bn issued in Q2 and only €20bn YTD (80% lower y/y), new issuance has been very low.

In credit rating news, S&P upgraded Premier Foods PLC to BB from BB-. In sector news, real estate came under attack as SBB, the Swedish real estate group, was hit by Viceroy reports directed at them. Other real estate names suffered by association. At Adler Group, an earlier Viceroy target, the chairman mentioned breaking up the company as an option to the firm's current difficult situation. Without auditors (KPMG resigned) and given the investigation by German financial watchdog BaFin, we see 'limited potential for recovery' under the current scenario.
In M&A news, Atlantia announced the acquisition of Yunex Traffic from Siemens for €950m.

Asian credit

The Government of India has imposed a windfall tax on crude oil and levied export duties on petrol, diesel and aviation turbine fuel. For crude oil, the windfall tax is INR23,250/t ($294/t) which translates to around $41/bbl. With regards to refined products, the export duties are INR6/litre and INR13/litre for petrol and diesel respectively. The government also announced that 50% of gasoline and 30% of diesel from domestic refineries must be dedicated for domestic consumption. The finance minister stated that the imposed taxes would be reviewed every 15 days. This latest tax environment is negative for the oil producers (ONGC, Oil India, Cairn India) as well as Reliance Industries, which exports around 70%-80% of its refined products.

Globe Telecom (Philippines mobile telecommunications operator) is reportedly in talks to sell around 6,000 towers in a sales-and-leaseback transaction. The bidders include a consortium of Stonepeak Partners/Manila Electric as well as Partners Group Holding and Aboitiz Group.

In the Chinese property sector, Shimao Group missed paying a $1bn bond that matured on 3 July. Sunac China received bondholders' consent to partly defer the amortization payments in June (10%) and September (15%) for its CNY4bn 4.78% onshore bond. This bond was puttable in April 2022 and the company secured bondholders' approval for an 18-month extension repayment for which it paid the first instalment of 10% in May.

Emerging markets

As global risk assets sold off, emerging market bonds were no exception. Over the quarter, hard currency sovereigns posted a negative return of -11%. While spreads were initially resilient in the first half of the quarter, significant widening took place in June as inflation pressures increased, global growth expectations diminished, and fears of a recession created headwinds for the asset class. Against this backdrop, spreads on the JPM EMBI Global widened 78bps to 460bps, and high yield assets bore the brunt, widening 239bps, most notably in Africa, as less liquid, high beta names suffered the most.

China's zero covid policy remains in place; however, restrictions have eased a little, giving hope that economic activity should improve, and a moderate growth rebound should follow.

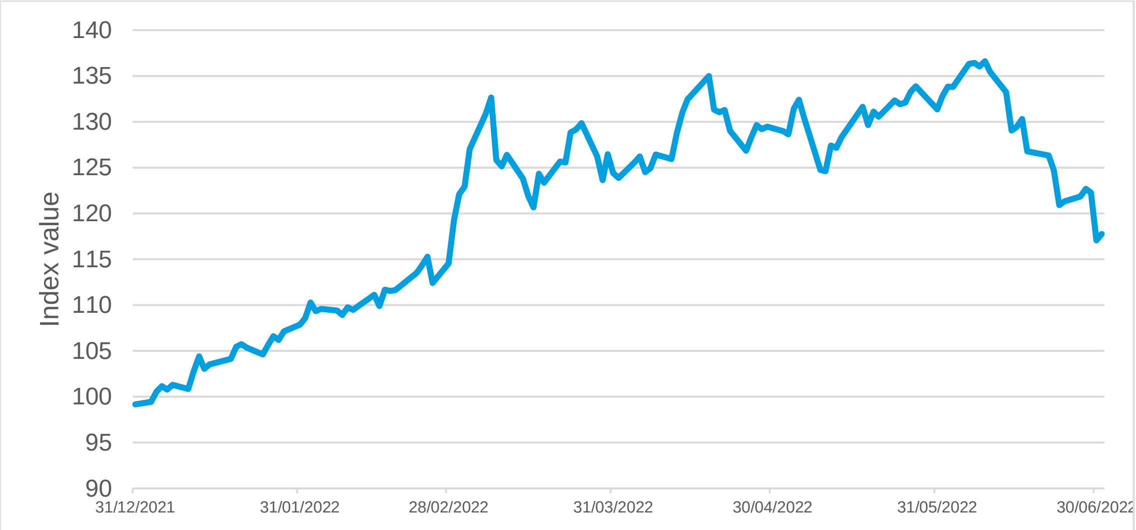
Latin American politics have been lively; Columbia elected populist Gustavo Petro, and Ecuadorian President Lasso survived an impeachment vote. War in Ukraine continues as sanctions have not been able to curtail Putin's ambitions. The invasion has sent food and energy prices higher, contributing further to the global inflation problem. However, central banks in emerging market regions have, on the whole, been proactive utilising monetary policy to combat rising inflation; we've seen many hikes in Latin America and Europe and expect to see Asian policy makers beginning their hiking cycles soon.

Commodities

Commodities, unlike many other asset classes saw a reversal of fortune in the second quarter **(see third chart of the week).** Oil prices were an outlier, however, and rose around 6+% in Q2 though that was eclipsed by European natural gas prices, which rose nearly 15%.

For other areas of the commodity complex fears of recession tore into sentiment and forced prices lower, such as industrial metals. This was notable last week with weaker zinc prices. Meanwhile hopes of increase in grain exports from Ukraine dented such prices, which fell around 7% in the last seven days.

Third chart of the week: Commodity prices – YTD 2022



Source: Bloomberg, Columbia Threadneedle Investments, as at 1 July 2022.

Responsible investments

Social bond issuance suffered the most this quarter, and YTD, as under half as many bonds have been issued in 2022, in comparison to last year. However, social issuance had a boost from the numerous emergency response 'Pandemic Bonds' being issued in 2020 through to the beginning of 2021, but even generally speaking social, green, sustainable and sustainability-linked bond issuance has been down this year. Total issuance for the ESG market stands at $500bn, down around 20% from this time last year, according to Bloomberg. Green bonds still take top spot on the podium for most issuance YTD, on the back of gatherings such as COP26 and other various environmental summits over the last 12 months, the effect has very much lasted with corporates, governments and supranationals continuing to bring green deals to the market.

As we look ahead, the second half of 2022 will bring numerous regulations and changes into effect, meaning some so-called 'ESG' labelled securities and funds may lose that title as rules are made stricter.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

4th July 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	■ Credit spreads have widened from March volatility- driven tightening, as we are seeing a market-wide softening in technicals fundamentals. This, along with rates-driven credit vulnerability, **has kept the group negative on credit risk** ■ We are past the peak of economic growth, with the first hike 75bps done and expectations for more 50/75bp hikes through the end of 2022. Pullback in liquidity created opportunity for market volatility. ■ Uncertainty remains elevated due to fears surrounding pace of central bank hiking, inflation, recession probabilities, and the Russian invasion of Ukraine.	■ Upside risks: lowered volatility once expansionary environment is established as the new normal ■ Downside risks: simultaneous low unemployment, high inflation, hiking, and slowing growth cause a recession. More spillover from Russian invasion, sanctions difficult to remove post-conflict. New Covid lockdowns. Supply chain disruptions, inflation, commodity shocks persist to H2 2022
Duration (10-year) ('P' = Periphery)	Short -2 -1 (¥) 0 (P, €) +1 ($, £) +2 Long	■ Carry offered by front end yields now attractive in UK ■ Longer yields to be captured by long-run structural downtrends in real yields ■ Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures ■ Hiking cycles may be curtailed by weakening growth, as risk of a policy error increases	■ Inflationary dynamics become structurally persistent ■ Labour supply shortage persists; wage pressure becomes broad and sustained ■ Fiscal expansion requires wider term premium ■ Long run trend in safe asset demand reverses
Currency ('E' = European Economic Area)	Short -2 -1 0 (¥, A$, EM, $, €, £) +1 +2 Long	■ The invasion of Ukraine will hit global growth, hinder risk markets and lend a bid to the Dollar ■ The repricing of the ECB has so far failed to boost the Euro as Eurozone growth expectations have underperformed the US	■ End of zero-covid strategy in China normalises supply chains and raises global growth, to the detriment of the Dollar
Emerging Markets Local (rates (R) and currency (C))	Under-weight -2 -1 0 (R, C) +1 +2 Over-weight	■ Substantial monetary policy tightening now embedded into EM local rates ■ Aggressive Fed pricing may now open the door to selective EMFX performance ■ EM real interest rates relatively attractive, curves steep in places	■ Negative sentiment shock to EM fund flows ■ 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	■ Spreads more attractive, new optimism for struggling fundamentals motivated upgrade despite weak technicals. ■ Fundamental headwinds: elevated fiscal deficits, rising debt to GDP ratios, significant inflation, Chinese growth, idiosyncratic political risks, increasing use of IMF programs ■ Fundamental consequences of invasion are unevenly distributed via trade links and commodity exposure. Good for commodity producers, bad for resource importers ■ Focus on buying strong relval opportunities as headwinds and volatility increase	■ Chinese growth derails with softer policy stance after shutdowns ■ Continued spillover from Russian invasion: local inflation (esp. food & commodity), slowing growth ■ A replay of 2013 occurs with a taper tantrum or swift appreciation of the USD ■ Persisting COVID growth scars hurt economies & fiscal deficits ■ Weaking technical with large fund outflows and slower supply
Investment Grade Credit	Under-weight -2 -1 ■0 +1 +2 Over-weight	■ US & EMEA spreads have widened since last month. Index last hung out at these yield levels in June 2010. ■ Despite strength in fundamentals (leverage, debt, service capacity, liquidity), we are past peak in credit quality for the cycle. Inflation, monetary tightening and technicals remain headwinds ■ Liquidity remains erratic, with heightened volatility and wide new issue concessions taking focus away from secondaries.	■ Supply dynamics remain a headwind ■ Rate environment remains volatile ■ Investors return to government bonds from IG as their risk/return preference for safe assets is changing in new rate environment ■ Russian invasion worsens operating environment globally
High Yield Bonds and Bank Loans	Under-weight -2 ■-1 0 +1 +2 Over-weight	■ Spreads have widened since last month, still inside of long-term medians. New focus on higher quality & risk management; expect volatility to continue. ■ In EMEA, spreads at previous recession points and reflect default outlook. Elevated risks for EMEA HY because of proximity to Russian invasion. ■ Primary market slow and weak liquidity in secondary ■ Bank loan market drifted lower with more volatility; sentiment weakening over slowing economy and higher interest cost, still see primary market support ■ Bonds & loan defaults set to remain near historic lows	■ Default concerns are focused on demand destruction, margin pressure and macro risks ■ Loan technicals and flows weaken ■ Waves of ratings upgrade continue into this year. ■ Russian invasion significantly rattles US bond loan/market as already seen in EMEA from commodities.
Agency MBS	Under-weight -2 -1 ■0 +1 +2 Over-weight	■ Mortgages recently outperformed as volatility dropped. ■ Higher Coupon securities are the most attractive, as lower coupons appear vulnerable due to tight valuations, poor carry and upcoming Fed sales and less money manager sponsorship. ■ A preferred place to add positions in TBA, pools and IIO	■ Housing activity slows and rising rates move prepays to normal levels without hurting mortgage servicing rates. ■ Uncertainty with the Fed hiking schedule and long-term position within the Fed balance sheet
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 ■0 +1 +2 Over-weight	■ Our preference remains for Non-Agency RMBS ■ RMBS: Fundamental performance remains strong but expect normalization coming from heavy supply, extension concerns, and general risk off. Like higher quality collateral ■ CMBS: Fundamentals remain mostly solid but weakening. Widening has shifted relval preference to other sectors. ■ CLOs: Spreads have been widening in sympathy with structured product credit; secondary bonds difficult to source as sellers became buyers. ■ ABS: US consumer looks well positioned, watching performance given inflation & rates.	■ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening, consumer retail/travel behavior fails to return to pre-covid levels ■ Work From Home continues full steam-ahead post-pandemic (positive for RMBS, negative for CMBS). ■ SOFR deals slows CLO new issue ■ Rising interest rates dent housing market strength
Commodities	Under-weight -2 -1 ■0 +1 +2 Over-weight	■ o/w Copper & Lead vs Zinc ■ ow Livestock ■ o/w Softs ■ o/w Grains ■ u/w Gold ■ o/w Oil	■ Global Recession