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FUND COMMENTARY – Q4 2023

CT (Lux) European Social Bond



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Fund Manager
Since: 30/06/2022

Fund Information

You are investing in a fund that is actively managed in reference to the benchmark below. Please refer to the Prospectus and KIID for the Fund objective.

Fund Benchmark: 50% ICE BofA Euro Non-Sovereign Index, 50% ICE BofA Euro Corporate Euroland Issuers Index

Inception Date: 23/05/2017

Fund Currency: EUR

Fund Domicile: Luxembourg

SFDR: Article 9*

Summary

- European investment-grade bonds posted strong gains over the fourth quarter.
- Gross of fees, the fund returned 5.87% and outperformed its benchmark.
- We bought several new issues, including a new green bond from ASR Nederland and a new social bond from Banco BPM.

Market Background

The fourth quarter (Q4) of 2023 proved to be a strong period for most asset classes, and investment-grade (IG) corporate credit was no exception, with the fund's benchmark returning 5.64%. Underlying core government bond yields fell sharply, and corporate bond prices were further boosted by a tightening in credit spreads (the yield premiums over 'risk-free' government bonds).

The index's strong return came despite a poor October. Treasury yields rose in response to surprisingly robust US economic data and concerns about increased Treasury issuance, while credit spreads widened as the terrible events in Israel and Gaza weighed on risk appetite. From late October onwards, however, yields and spreads trended lower as fears of a wider conflict in the Middle East subsided. As key measures of inflation continued to slow in the US, the UK and the eurozone, investors were also encouraged by a growing belief that the major central banks – led by the Federal Reserve – would start to cut interest rates sooner than previously thought.

The Fed continued to keep rates on hold during the quarter, and its commentary became increasingly dovish. In November, Fed Chair Jerome Powell noted the tightening effect on the economy of higher Treasury yields and mortgage payments. December's policy meeting was seen as even more of a departure. Powell acknowledged slowing growth and progress on inflation, and the Federal Open Market Committee reduced its median rate projection for the end of 2024 from 5.1% to 4.6% – 75 basis points (bps) below the current level. Markets were more optimistic and, by the end of the month, were pricing in more than 150 bps of cuts before 2025, with the first seen arriving in March.

As in the US, key measures of inflation fell more than expected in Europe and the UK. The European Central Bank and Bank of England also held rates steady, but both maintained their 'higher for longer' rhetoric, even after the Fed's dovish pivot. Commenting on the ECB's December meeting, President Christine Lagarde insisted that there had been no discussion of rate cuts at all. The BoE's nine-strong Monetary Policy Committee – of which three members voted for a hike at both meetings in Q4 – reiterated in December that rates could still rise if necessary and were likely to be "restrictive for an extended period" as "key indicators of UK inflation persistence remain[ed] elevated".

Nevertheless, markets appeared sceptical, perhaps reflecting the relative weakness of the eurozone and UK economies – both of which were reported to have contracted during Q3. Gilt and bund yields fell over the remainder of the year and traders priced in more aggressive ECB and BoE rate cuts in 2024.

Meanwhile, credit spreads tightened alongside a rally in equities as anticipation of rate cuts and hopes of a 'soft landing' for the US economy bolstered investor appetite for risk. Equities and corporate bonds were further supported by encouraging Q3 corporate results, which continued to beat expectations in aggregate. Credit markets were also boosted by favourable technicals as strong inflows were met with light new issuance of corporate debt and light dealer inventory. Of the three main regional IG markets, the US fared best in risk-adjusted spread terms: US dollar, sterling and euro IG spreads narrowed by about 16.8%, 12.9% and 9.9% respectively (per ICE BofAML indices). By sector, top performers on this basis included telecoms and real estate. Insurance and automotive were among the laggards, but the rally was broad-based, with spreads in all sectors tightening significantly.

In sustainability news, COP28 culminated with a joint statement featuring the strongest wording yet on "transitioning away from fossil fuels". The conference also featured pledges to triple renewable and nuclear energy capacity by 2030 and 2050 respectively. Earlier in the quarter, the European Union announced several support measures for the wind energy industry. The EU Wind Package aims to increase the adoption of inflation-linked wind energy pricing and speed up the permit process for new projects. 2023 finished with labelled issuance of over \$900bn, with green bonds representing more than half of this amount. As governments aim to fund their net-zero transitions, there has been a noticeable uptick in sovereign green bond issuance.

*The fund has a sustainable investment objective and is categorised as Article 9 under the EU Regulation 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR).

Performance

12M Rolling Period Return in (EUR) - as at 31 December 2023

Past performance does not predict future returns and future returns are not guaranteed.

	12/22-12/23	12/21-12/22	12/20-12/21	12/19-12/20	12/18-12/19	12/17-12/18
Fund (Gross) %	8.03	-15.00	-1.90	3.53	6.07	-0.83
Index (Gross) %	7.50	-14.49	-1.46	2.74	5.72	-0.77

Source: Columbia Threadneedle Investments as at 31/12/2023. Gross of fee fund returns are time-weighted rates of return net of commissions transactions costs and non-reclaimable taxes on dividends interest and capital gains using pricing of investments which is either the last traded price or a bid basis. Cash flows are factored as of the end of the day and exclude entry and exit charges. Index returns include capital gains and assume reinvestment of any income. The index does not include fees or charges and you cannot invest directly in it. The return of your investment may change as a result of currency fluctuations if your investment is made in a currency other than that used in the past performance calculation.

For detailed information on Fund Changes please see Significant Events - Threadneedle (Lux) Funds PDF available on www.columbiathreadneedle.com/en/changes

Gross of fees, the fund returned 5.87% over the quarter and outperformed its benchmark¹.

Credit strategies made a positive relative contribution, led by beneficial credit selection. At the issuer level, top contributors included bonds from real estate firm Vonovia, Motability and logistics property owner Prologis. Meanwhile, detractors included bonds from insurers Generali and AXA. Asset allocation had a neutral impact on returns and industry allocation detracted modestly. The latter was mostly due to an underweight in the automotive sector.

Rates strategies made a small positive contribution. This was entirely due to beneficial curve positioning, especially in 5–10-year bonds.

On the social side, the average social intensity score ended 2023 at 20, with the proportion of the fund in category A impact investments at 38%. The proportion of the fund in the lowest social intensity bonds (C3 and C4) was still well below the limit set by the social advisory panel at 9%. Overall, this marks another steady quarter of benefits to society through the bonds purchased by the fund. The fund aligns each holding with one of the 17 United Nations Sustainable Development Goals. The fund's largest weights are currently in goal 11 (Sustainable Cities and Communities), goal 3 (Good Health and Well-Being) and goal 7 (Affordable and Clean Energy).

Activity

Our primary market activity included buying a new general corporate purposes issue from private health insurance provider Bupa in October. Originating in the UK, Bupa now has 82,000 employees serving 43 million customers worldwide with health insurance and healthcare, as well as aged care services. The firm aims to improve health and healthcare, helping people live longer, happier lives. We also bought green sovereign bonds from the Austrian government in a tap issue. Austria initially issued the bonds in May 2022, primarily to fund clean public transport with a focus on the upgrade, electrification and expansion of railway lines.

In November, we bought a new social bond from Italian lender Banco BPM. The four-year issue, which is the first under Banco BPM's recently published green, social and sustainability bond framework, will be used to finance eligible loans related to positive social outcomes. Loans can be made to SMEs located in provinces where the GDP per capita is below the Italian national average as well as areas impacted by natural disasters. We also bought a new green issue from Telefonica, the company's third such offering in 2023. The proceeds will mainly be used to modernise and improve the energy efficiency of Telefonica's network assets. During November, the firm announced that it aims to link 40% of its financing to ESG criteria by 2026. In December, our only primary market purchase was a new green issue from ASR Nederland. The Dutch insurance group issued its inaugural green bond, following the publication of its Green Finance Framework in 2022. The funds will be used to invest in eligible projects, including green buildings, renewable energy and clean transport.

We added to several exiting positions in the secondary market. In the banking sector, we topped up exposure to green bonds from banking group DNB and social bonds from several lenders including Crédit Agricole, Intesa Sanpaolo, BBVA and NatWest. In the real estate sector, we added to social bonds from Vonovia and green bonds from Digital Realty, Prologis and Segro European Logistics Partnership. Elsewhere, we added to green bonds from telco Swisscom and utilities Amprion and Eurogrid, as well as social bonds from the EU and French government agency UNEDIC. We also added to sustainability bonds from pharmaceutical Sanofi, Erste Bank and the European Investment Bank.

On the other side, outright sales included Austrian export credit bank OeKB, Hungarian state-owned development bank MFB and green bonds issued by Dutch lender Rabobank. We also exited our holdings in social bonds issued by Deutsche Kreditbank and dairy products group Danone, as well as general corporate purposes bonds from Danish bank Nykredit and Italian energy infrastructure firm Snam. In addition, we trimmed several holdings including French government agencies RTE, CADES and Société du Grand Paris, as well as the Île-de-France region.

Outlook

One of the chief impediments to tighter spreads has been restrictive monetary policy. This headwind appears to be easing thanks to the Fed's dovish pivot, which will make it increasingly difficult for the ECB (and BoE) not to follow suit. The eurozone may slip into recession in 2024, but any such downturn will likely be mild. In any case, we expect credit quality to remain strong. The technical backdrop also looks benign. With investors keen to lock in higher yields before the rate cuts expected later this year, markets seem to be having little trouble digesting the usual post-holiday surge in new issuance.

As regards valuations, euro IG spreads ended December very close to their five- and 20-year averages, though still cheaper on this basis than their sterling and dollar counterparts. Furthermore, the yield on the market remains well above the long-run average and a far cry from the sub-1% levels we were seeing only a couple of years ago. This represents an interesting entry point, in our view, for those seeking income without too much risk.

All things considered, we see the outlook for euro IG spreads as neutral to slightly positive.

Key Risks

The value of investments can fall as well as rise and investors might not get back the sum originally invested.

Where investments are in assets that are denominated in multiple currencies, or currencies other than your own, changes in exchange rates may affect the value of the investments.

The fund invests in securities whose value would be significantly affected if the issuer refused, was unable to or was perceived to be unable to pay.

The fund holds assets which could prove difficult to sell. The fund may have to lower the selling price, sell other investments or forego more appealing investment opportunities.

Changes in interest rates are likely to affect the fund's value. In general, as interest rates rise, the price of a fixed rate bond will fall, and vice versa.

The fund's assets may sometimes be difficult to value objectively and the actual value may not be recognised until assets are sold.

The fund may invest in derivatives (complex instruments linked to the rise and fall of the value of other assets) with the aim of reducing risk or minimising the cost of transactions. Such derivative transactions may benefit or negatively affect the performance of the fund. The Manager does not intend that such use of derivatives will affect the overall risk profile of the fund.

The fund aims to invest in assets that are deemed to be supporting and funding socially beneficial activities and development and utilises a Social Rating Methodology. This will influence the fund's exposure to certain issuers, industries, sectors and regions, and may affect the relative performance of the fund positively or negatively.

The fund may exhibit significant price volatility.

The risks currently identified as applying to the fund are set out in the "Risk Factors" section of the prospectus.

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