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This is a marketing communication. Please refer to the prospectus of the UCITS and to the KIID before making any final investment decisions.

FUND COMMENTARY – Q3 2022

Threadneedle (Lux) European Social Bond

Tammie Tang
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 8*

Summary

- Credit markets had another weak quarter.
- Gross of fees, the fund returned -3.88% over the period, outperforming its benchmark, which returned -3.71%.
- We took part in new green-bond issues from Amprion, DNB Bank and Segro, among others.

Market Background

Measured by the fund's benchmark, euro investment-grade (IG) credit returned -3.71% for the third quarter (Q3). This was primarily driven by a sharp rise in core yields, as major central banks grappled with persistent inflation at or close to multi-decade highs in their respective economies.

The Federal Reserve, European Central Bank and Bank of England were all in action during Q3, raising rates by a total of 150 basis points (bps) in the US, 125 bps in the eurozone and 100 bps in the UK. In the ECB's case, this brought an end to eight years of negative rates. All three central banks signalled further hikes to come.

UK bonds were further pressured by concern over the fiscal credibility of the new government. Gilt yields soared to peripheral eurozone levels, sterling plunged and lenders pulled hundreds of mortgage deals after a 'mini-budget', including some £45bn in tax cuts, was announced with no supporting projections from the Office for Budget Responsibility (OBR). The BoE was forced to intervene, offering to buy up to £65bn in long-dated gilts within two weeks to avert a potential pensions crisis. Since quarter end, the Treasury has abandoned a tax cut for high earners and says its next fiscal statement – this time backed by OBR forecasts – will be brought forward to October.

In the US, hopes of a dovish pivot faded. Although GDP was shown to have contracted in Q1 and Q2, the Fed appears to be focusing more on the labour market, which remains buoyant, and – of course – stubbornly high inflation. While headline inflation fell slightly in August (along with petrol prices), core inflation climbed back towards March's 40-year high. In September, the Fed released a more hawkish 'dot plot' alongside its third consecutive rate hike of 75 bps. The policymakers' median projection was now signalling a terminal interest rate of 4.6% next year, up from the prior forecast (in June) of a 3.8% peak.

While credit spreads – the yield difference between corporate and 'risk-free' government debt – widened considerably this year, the widening seen over Q3 was relatively modest (just 11 bps as measured by the benchmark index). Spreads tightened in July and early August alongside a rally in equities that was fuelled in part by another better-than-expected earnings season. However, this move was reversed over the remainder of the period as risk appetite evaporated. On top of inflation and rate-hike fears, sentiment was dampened by concerns about the economic impact of the war in Ukraine, especially the potential for energy shortages in Europe. So far this year, euro IG has significantly underperformed the US and sterling markets in spread terms, in part because of the region's greater exposure to the war.

Sustainability Developments

In ESG news, President Biden said in a speech that the climate crisis represented a "clear and present danger" but stopped short of formally declaring a climate emergency (which would require legal procedures). The comments came alongside an announcement that plans were in place to expand wind power generation development in new areas along the US coast.

Less positively, the drive for energy security may increase the use of non-renewable energies in the short term, as has been seen throughout Q3. In the UK, restrictions on North Sea oil production are to be reviewed. The UN Race to Zero softened its language around the use of coal – from 'exclude' to 'phase out' in certain circumstances. Meanwhile, a report from the International Energy Agency (IEA) and the OECD showed a near-doubling of spending on oil, coal and gas to nearly $700bn in 2021, with further increases expected this year.

According to Bloomberg data, ESG issuance for Q3 was much weaker than the same period last year. Approximately $70bn came to the market, a further decline on the last two downward-facing quarters. Year-to-date supply is around 20% lower, with sustainability bonds faring worst.

*The Fund is categorised an Article 8 under the EU Regulation 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR) and promote environmental or social characteristics as an objective. Please refer to www.columbiathreadneedle.co.uk for further disclosures. The decision to invest in the promoted fund should take into account all the characteristics or objectives of the promoted fund as described in its prospectus.

Performance

12M Rolling Period Return in (EUR) - as at 30 September 2022

	09/21-09/22	09/20-09/21	09/19-09/20	09/18-09/19	09/17-09/18
Fund (Gross) %	-16.30	0.25	0.82	7.19	-0.14
Index (Gross) %	-15.77	0.78	0.21	6.44	0.05

Source: Columbia Threadneedle Investments. Based on global close valuations with cash flows weighted at start of day and excluding entry/exit charges and ongoing charges and net of transaction costs. The index does not include fees or charges and you cannot invest 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.
Past performance does not predict future returns and future returns are not guaranteed.

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 -3.88% for the quarter, underperforming its benchmark by 18 bps. Rates strategies were the main driver of the underperformance. Country positioning was unfavourable, due to the overweight in UK bonds. The duration (which measures sensitivity to changes in interest-rates) effect also detracted as we were long relative to the benchmark in an environment of rising yields. However, curve positioning was modestly beneficial. Within credit, selection was helpful, with notable contributors at the issuer level including grid operator Amprion, the Region of Madrid and medical-device manufacturer Becton Dickinson. However, this was outweighed by detraction from asset allocation and industry positioning. In the case of the former, an overweight in IG credit risk and off-index exposure to high-yield bonds were unfavourable as spreads widened. In terms of industry positioning, the overweight in banking and underweights in autos and basic industry proved unhelpful.

In another quiet period for the primary market, we took part in new green-bond issues from German grid operator Amprion, DNB Bank, property investment company Segro, Bank of Ireland, and the International Finance Facility for Immunisation (IFFIm). Amprion's €1.8 billion offering – its first green bond – will be used to finance sustainable grid expansion and transition projects. Meanwhile, proceeds from Segro's 5-year €750 million senior unsecured bond will initially be used to refinance the existing (non-green) €500 million bond maturing in 2023; subsequently, it will finance eligible green projects as outlined in the Segro Green Finance Framework, including the continued development programme as well as providing funding for general corporate purposes. Finally, proceeds from the £250 million IFFIm bond will be used to finance the Gavi immunisation programmes. These will include reaching "zero-dose" children and strengthening routine immunisation in low-income countries.

In the secondary market, we bought green bonds from Co-operative Bank, the German government and Prologis; social bonds from NatWest and Yorkshire Building Society; and a sustainability bond from Agence Française de Développement. On the sales side, we reduced the green bond holdings of real estate firm Digital Realty, SNCF and Iberdrola, and Vodafone; and sustainability bonds from United Utilities. We exited the position in green bonds of Italian energy firm ERG.

Overall, the average social intensity score rose slightly to a high of 19.8 with the proportion of the fund in (category A) impact investments up on last quarter at 35% (previously 34%). With the proportion of the fund in the lowest social intensity bonds (C3 and C4) still well below the limit set by the social advisory panel, this marks another steady quarter of benefits to society through the bonds purchased by the fund.

More broadly speaking, the beta of the fund was maintained at a modest overweight. Our active duration position moved marginally further underweight during the quarter.

Outlook

The prospects for IG credit remain mixed. On the negative side, the outlook is clouded by ongoing expectations of contractionary monetary policy. Furthermore, consensus forecasts for economic growth next year teeter on the brink of recession, albeit improving somewhat into 2024. Recessionary risks appear higher for Europe and the UK than elsewhere, with Europe most vulnerable to the energy supply crisis. In terms of corporate health, we see some signs of divergence in credit metrics between US and European issuers. The former are still expected to de-lever, while Europe's greater recessionary risk is leading to rising leverage forecasts there.

Valuations for euro IG are looking increasingly attractive, albeit not outstanding in historic terms. While global IG credit spreads finished September almost two standard deviations (SDs) above (i.e. cheaper than) the 5-year average, they were only a little over half an SD above the 20-year average – and less so if we adjust for the modest decline in credit quality and increase in duration that has occurred over these two decades. Euro IG therefore continues to stand out in valuation terms, with spreads ending the month 3.5 SDs and 1.4 SDs above their respective 5- and 20-year averages.

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

With all of these factors considered, we are left with a slightly positive outlook on the prospects for euro IG spreads.

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.

Most bond and cash funds offer limited capital growth potential and an income that is not linked to inflation. Inflation is likely to affect the value of capital and income over time. 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 investment policy of the fund allows it to invest in derivatives for the purposes of reducing risk or minimising the cost of transactions.

The fund may exhibit significant price volatility.

All the risks currently identified as being applicable to the Fund are set out in the “Risk Factors” section of the Prospectus. Please read the Key Investor Information Document and the Fund Prospectus if considering investing.

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