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FUND COMMENTARY – OCTOBER 2021
THREADNEEDLE (LUX) EUROPEAN SOCIAL BOND

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Summary

- European investment-grade credit delivered negative returns in October.
- Gross of fees, the fund returned -0.65%, modestly underperforming the benchmark[1].
- We bought new green bonds from Triodos and Vesteda and sustainability bonds from the EIB and EBRD.

Market Background

October was a poor month for European investment-grade (IG) credit, with the fund's benchmark making a negative total return of -0.62%. While equities bounced back after a weak September, euro IG credit spreads continued to trade in a narrow range, and indeed edged marginally wider overall. Continuing another trend, there was more day-to-day movement in underlying German bunds and other core government bonds. Core yields were volatile as investors struggled to gauge how persistent the current inflationary pressures might be, particularly given recent wage rises in developed economies, and how aggressively central banks might act in response.

There was also a marked flattening in the major yield curves. Yields at the short end were driven higher by rate-hike fears; those at the long end fell as long-term inflation expectations stabilised towards month end after a sharp rise. The 5-year bund yield rose 17 basis points (bps) to -0.39% while the 30-year yield fell 14 bps to 0.14%.

The current trend of rising inflation and slowing growth has brought with it increased concerns about the potential for 'stagflation'. IHS Markit's flash composite purchasing managers' index for the eurozone showed the slowest expansion in six months as supply-chain problems continued to bite. Earlier in the month, the IMF had cut its forecast for Germany's 2021 growth from 3.6% to 3.1%, citing supply disruptions, though it raised the forecast for the euro area as a whole from 4.6% to 5.0%.

Meanwhile, the European Central Bank went into its policy meeting with eurozone inflation running well above target: September's figure had been confirmed at a 13-year high of 3.4%. Despite this, the bank kept its bond-purchase programme unchanged. ECB President Christine Lagarde said that while inflation would likely be more persistent than initially feared, it should nevertheless fade next year without the need for a rate rise. This attempt at reassurance apparently failed, as short-dated bund yields soared and markets continued to price in a 2022 rate hike. Later, the preliminary inflation print for October came in at 4.1% – higher than expected and more than twice the ECB's target.

In ESG news, the EU launched its inaugural 12 billion euro 'green' bond. Proceeds will be used to fund around a third of the bloc's pandemic recovery package. Member states will need to submit payment requests as they reach environmental targets. Meanwhile, the UK issued its second tranche of ‘green’ gilts - the 2053 bond is the longest sovereign green bond issued to date and was just over 12 times oversubscribed. The UK government also released details on its strategy to achieve net-zero by 2050. The plans received mixed reviews with some environmental groups voicing concerns that the strategy is “riddled with holes and omissions”. As the month ended, the long-awaited COP26 climate change conference got underway in Glasgow. Its aim is to accelerate action towards the goals of the 2015 Paris Agreement and the UN Framework Convention on Climate Change.

Performance and Positioning

Gross of fees, the fund returned -0.65% in October, modestly underperforming the benchmark, which returned -0.62%. Over the year to date, the fund returned -1.95%, 51 bps behind its benchmark[1].

Credit strategies weighed on relative performance in October, mainly due to unfavourable security selection. Marginal detractors at the issue level included bonds from German state North Rhine-Westphalia and the EU. Rates strategies were positive in aggregate, reflecting favourable country and curve positioning.

New issuance came in much lower than in September, as was expected given the start of the earnings season. We participated in new green offerings from sustainable bank Triodos and residential property company Vesteda, as well as sustainability issues from the European Investment Bank (EIB) and the International Bank for Reconstruction and Development (IBRD).

The Triodos deal is the firm’s first green bond and will be used to fund lending in renewable energy, environmentally sustainable management of living natural resources and green buildings. Vesteda’s 10-year issue is the company’s second green offering and will further ESG initiatives; proceeds will be used to finance homes with an Energy Performance Certificate (EPC) rating of ‘A’ and homes which have made an improvement of at least two EPC label-steps up to a minimum rating of ‘C’, as well as new build homes that have an energy performance coefficient of 0.4 or better.

In the secondary market, we added to a range of positions, including green bonds from Digital Realty, Telefónica, Eurogrid and Vodafone; social bonds from the EU and Spanish state-owned lending organisation ICO; and general corporate purpose issues from airport operator Avinor and German grid operator Amprion. On the sales side, we exited BT and Ausgrid, while reducing exposure to a number of issuers including Akelius Residential Property, GlaxoSmithKline and banking groups Rabobank, ING and Belfius.

Outlook

We retain a fairly neutral view in terms of the outlook for spreads. In spite of a little more hawkishness from central banks, we feel that policy conditions are likely to stay supportive into the coming quarter. Meanwhile, although growth is expected to ease from the pace recorded in the second quarter, GDP data should remain positive. This ‘not too hot, not too cold’ environment is a healthy background for the IG market.

Our team of credit analysts expect corporate credit quality to continue improving and, by the end of this year, to be broadly similar to how we were towards the end of 2019. For banks, we anticipate a falling ‘cost of risk’, with ‘normalisation’ achieved by 2022. Margins, though, are likely to remain under pressure, capital ratios are likely to decline (albeit staying at healthy levels), and loan growth is expected to remain modest in Europe and the US.

As for technical factors, market issuance should come in below the levels seen last year, while demand for income-generating assets is still a positive force.

So why, then, aren’t we more bullish? The problem is one of valuations (spreads) and how those sit in the historical context. European IG spreads ended the period around 0.5 standard deviations richer than the 20-year average, and richer still over shorter periods.

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[1] Past performance does not predict future returns. Please refer to the KIID document found on our website for further information on the fund performance.

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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.

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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.

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