COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

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

Simon Bond
Fund Manager

Summary

- European investment-grade credit delivered positive returns in November.
- Gross of fees, the fund returned 0.44%, outperforming the benchmark[1].
- We bought new green bonds from NatWest and TenneT and a sustainability-linked bond from Kerry Group.

Market Background

European investment grade (IG) credit delivered a small positive return of 0.36% in November as measured by the fund's benchmark. In a departure from the trend that had been in place since April, spread volatility returned to the market during the month. This was mainly driven by the discovery of the Omicron coronavirus strain in South Africa, but even before that there was a lot of troubling news for markets to digest. Among other developments, Covid cases surged in Europe, tensions escalated between Russia and Ukraine, Belarus threatened to disrupt the EU's gas supply, and US inflation reached a 31-year high.

For credit specifically, higher-than-expected new issuance was added to these already challenging conditions. Global IG credit spreads broke out of their narrow trading range and finished the month some 15% wider in risk-adjusted terms. Euro IG spreads fared worst, widening over 26% on the same basis, while US dollar and sterling counterparts increased by 16% and 10% respectively. The underperformance of euro IG seems to have been partly due to technical selling triggered by a cheapening of euro swaps relative to German bunds; swaps bore the brunt of rising inflation expectations, as bunds were insulated to a degree by ongoing central bank purchases.

The weakness in IG spreads was offset by strength in underlying core government bonds, though their advance was likewise far from smooth. Yields on US Treasuries, UK gilts and German bunds all fell early in the month as the relevant central banks were seen to be more dovish than expected. The Federal Reserve began to taper its bond purchases, as had been well flagged in advance, but didn't signal any greater hurry to start raising rates. The Bank of England decided against a widely expected rate hike, while the president of the European Central Bank said that rates in the eurozone were "very unlikely" to rise next year.

Later, yields rose in response to the jump in US inflation before falling back on worries about the resurgent pandemic in Europe. News that Austria was to impose a national lockdown helped push even the far end of the German yield curve below zero. Treasuries came under pressure again a few days later when Jerome Powell, rather than a supposedly more dovish candidate, was renominated as Fed chair. Towards month end, Powell said that the word 'transitory' could be retired as a description for current US inflation, and that tapering might have to accelerate. This hawkish shift was unable to derail the Omicron-driven rally in core bonds, but Treasuries did lag gilts and bunds.

In ESG news, the COP26 climate change conference concluded with an agreement that, while weaker than many had hoped for, marked a significant step forward. Importantly, countries have been asked to come back to the table with enhanced pledges aligned with a goal of limiting global warming to 1.5 degrees Celsius in 2022, instead of the usual five-year cycle. Elsewhere, the Bank of England began enforcing green criteria when purchasing corporate bonds. Companies will need to satisfy 'climate-related eligibility criteria before being bought, and a scorecard will be created for each issuer with details of these factors, which will be made available to all investors. The European Central Bank is expected to follow suit with a similar process.

Performance and Positioning

Gross of fees, the fund returned 0.44% in November, outperforming the benchmark, which returned 0.36%. Over the year to date, the fund returned -1.52%, 43 bps behind its benchmark.[1]

Credit strategies were the main driver of outperformance over the month. A modest overweight in IG credit risk and off-index exposure to high-yield bonds proved unhelpful as spreads widened. However, this was more than offset by gains from favourable industry positioning and credit selection. In terms of selection effects, marginal positive contributors at the issuer level included Thames Water, E.ON and Rabobank. Rates strategies were marginally positive in aggregate, reflecting favourable duration and curve positioning.

As mentioned, new issuance picked up despite the uncertain backdrop. We took part in a range of new issues over the month. These included green bonds from banking group NatWest and utility companies Électricité de France (EDF), TenneT and Stedin; a social bond from Spanish state-owned lending organisation ICO; a sustainability-linked issue from food and beverage group Kerry; and a general corporate purpose issue from insurer Allianz.

TenneT's €1 billion senior green offering - its largest ever issue - will be used to finance green power transmission projects, with a focus on connecting large-scale offshore wind farms to the onshore electricity grid and enhancing the onshore transmission capacity for renewable energy. Kerry's sustainability-linked framework is aimed at further improving the group's sustainability strategy and commitments, which are centred around the firm's vision of offering 2 billion people sustainable nutrition by 2030.

In the secondary market, we increased exposure to a number of positions including green bonds from property company Vonovia and utilities E.on and ERG; social bonds from Italian development bank Cassa Depositi E Prestiti;; and general corporate purpose issues from Holcim Finance and Bupa.

On the sales side, we exited Telecom Italia and French public finance company AFD, while reducing issuers including banking groups Banque Fédérative du Crédit Mutuel, Rabobank and La Banque Postale, and railway companies Deutsche Bahn and SNCF.

Outlook

Little can be deduced about the potential impact of the Omicron strain until more is known about its severity, transmissibility and the protection offered by current vaccines. Early evidence on its severity suggests grounds for cautious optimism.

Leaving that question aside for the meantime, then, we retain our neutral view on the outlook for spreads. While the Fed has started its journey to normalisation, monetary policy conditions are still supportive and expected to remain so in the coming months. Meanwhile, although GDP growth has eased of late, it remains 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 to have regained pre-pandemic levels by the end of the year. As for technical factors, market issuance should remain below the levels seen last year, while demand for income-generating assets remains a positive force.

[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.

So why, then, are we not more bullish? The problem is one of valuations (spreads) and how those sit in the historical context. Despite the widening seen in November, global IG spreads went into December about 0.5 standard deviations richer than the 5-year and 20-year averages.

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.

Performance attribution source FactSet, calculated using a daily time-weighted methodology based on gross returns as at global close on the last working day of the month.

columbiathreadneedle.com