COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

4 JANUARY 2021

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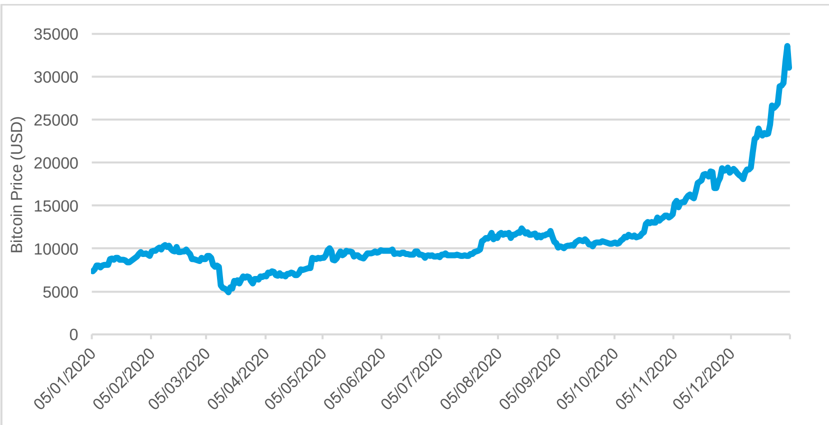
Here we go again.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.93%	1 bps	-0.3%	8.2%
German Bund 10 year	-0.60%	-5 bps	-0.1%	3.0%
UK Gilt 10 year	0.18%	-8 bps	1.7%	8.8%
Japan 10 year	0.02%	0 bps	0.0%	-0.8%
Global Investment Grade	103 bps	-2 bps	0.5%	7.7%
Euro Investment Grade	93 bps	0 bps	0.1%	2.6%
US Investment Grade	103 bps	-3 bps	0.5%	9.8%
UK Investment Grade	99 bps	1 bps	1.5%	8.0%
Asia Investment Grade	235 bps	-1 bps	0.4%	6.3%
Euro High Yield	369 bps	4 bps	0.8%	2.9%
US High Yield	386 bps	-19 bps	1.9%	6.2%
Asia High Yield	579 bps	-23 bps	2.3%	7.0%
EM Sovereign	323 bps	-6 bps	1.8%	5.9%
EM Local	4.2%	0 bps	3.5%	2.7%
EM Corporate	328 bps	-2 bps	1.5%	7.1%
Bloomberg Barclays US Munis	1.1%	-1 bps	0.6%	5.2%
Taxable Munis	2.1%	-2 bps	1.4%	12.1%
Bloomberg Barclays US MBS	39 bps	-3 bps	0.2%	3.9%
Bloomberg Commodity Index	170.20	1.3%	5.0%	-3.1%
EUR	1.2296	0.2%	2.4%	8.9%
JPY	102.82	0.3%	1.0%	5.1%
GBP	1.3692	0.8%	2.6%	3.1%

Source: Bloomberg, Merrill Lynch as at 31 December 2020.

Chart of the week: Cryptocurrency (Bitcoin) Rally – LTM



Source: Bloomberg, Columbia Threadneedle Investments as at 4 January 2021.

Macro / government bonds

It was a quiet end to the year for government bond markets with yields little changed. The resolution of the Brexit negotiations was widely anticipated and there was little impact to either bond yields or currency markets. The US dollar remains under pressure though moves against the euro and sterling were eclipsed by the rally in cryptocurrencies such as Bitcoin **(see chart of the week).**

There was evidence of the 'reflation trade' with US 10-year inflation expectations reaching almost 2%, which was the highest since late 2018. Staying in the US, we have the Georgia run-off elections later this week. Should the Democrats win both seats they would take control of the Senate; this brings a heightened risk of fiscal spending. We will get the non-farm payroll data at the end of this week and Global PMI data through the week, both of which will be the key focus points for markets.

Investment grade credit

It was a quiet end to the year but Q4, 2020 was another strong period for performance for investment grade credit markets.

Global investment grade spreads tightened by 25% in the last three months of the year closing the year at 103bps – barely wider for the the year as a whole. The chief reasons for such performance were the announcement of successful Covid-19 vaccinations and, on Christmas Eve, an agreement on Brexit between the UK and its European partners. The US dollar market was the best performer over the period with spreads tighter by 28% while euro markets were the laggard at 'only' 21% tighter. However, over the course of the year euro markets are modestly tighter and outperformed.

There was not much news flow to comment on. The Brexit resolution received a muted response from UK issuers, such as banks, though this was perhaps more to do with illiquid year end markets and that the outcome was widely expected. We are expecting a light calendar of new issuance in the coming weeks.

High yield credit

Trading volumes had started to subside as we moved into the Christmas season already registering at 50% of the previous weeks. Technicals continue to remain supportive for the asset class.
The European High Yield (EHY) market closed 2020 achieving a performance of +2.85% for the year as December's performance contributed to Q4's positive performance of +5.54%, clearing out the earlier negative performance of the asset class. Flows were light in the last week of December with a small outflow of €24 million, mainly in ETFs. New issuance reached a new historical high in 2020, finishing the year at €103.3 billion via 206 bonds. Much of the issuance was in BB bonds, posting the largest % weight at 62% with single B bonds achieving half of that.

'Fallen Angels' played a big role last year, increasing the EHY universe by more than €70 billion, through the addition of many major large sized corporates, especially those in the auto industry. This contributed towards increasing the size of the EHY universe to €433 billion, a 35% increase from the close of 2019. It also changed improved the credit quality of the universe as the percentage weight of BB bonds increased by almost 4% from the end of 2019.

The year finished with a number of new additional funding stories (British Airways £2 billion, 5-year export development guarantee facility loan); and M&A stories in the works (MGM's bid for Entain – owner of Ladbrokes; Richemont and Groupe Ecore; vote on the Fiat-Peugeot merger).

Structured credit

The US Agency MBS market was flat for the month of December on more stable interest rates. The sector generated a 3.9% total return for the full calendar year, lagging its longer duration, high-quality peers that benefited from a flattening yield curve over the course of 2020. The Covid-19 crisis left the RMBS market largely unscathed as low inventory combined with historically low interest rates and powered home price appreciation. The same cannot be said for the CMBS market, where delinquencies and loan modifications spiked as borrowers received payment relief. That said, after considerable price declines related to forced selling and ongoing shelter-in-place mandates in Q2 2020, investor appetite resumed; the selling abated; and the asset class experienced a dramatic move higher in prices initially bolstered by a robust economic recovery and then supported by breakthrough vaccine developments. Suffice it to say, the CMBS market was at the epicentre of divergent economic forces and fundamental views.

Emerging markets

EMD also had a strong finish for 2020 returning 5.9% for the year as hard currency spreads tightened another -5bps on the week, bringing December's spread change to -28bps to finish at 350bps. Corporate spreads were similar, also at 5bps for the week and -26bps for the month. Local currencies also returned +0.17% for the week and +2.07% for the month. Inflows remained steady into the close of the year at $2.9 billion, with $2.1 billion into local EM debt and mostly into managed accounts.

In central bank news, Thailand, Mexico and Colombia kept rates unchanged at 0.50%, 4.25% and 1.75% respectively, though the votes were more closely split than previously.

In country specific news, it was announced that Honduras will receive $90 million from the IMF after the organisation completed its third review of the country.

The year closed with the major news of a China / EU agreement, which will allow EU investors much more access to invest in the Chinese market. This comes after seven years of negotiations and tackles Chinese policies that were of particular concern to the EU (ie, industrial subsidies, state control of businesses, and mandated technology transfers).

Asian fixed income

Vedanta Resources (VRL) bought an additional 4.98% stake in Vedanta Ltd via a new SPV called Vedanta Holdings Mauritius II. This raised VRL's stake in Vedanta Ltd to 55.11%. VRL has also issued a $400 million note to Oaktree Capital Group, which is secured against three VRL subsidiaries; Vedanta Holdings Mauritius II, Westglobe and Finsider. These three subsidiaries own a total 17% stake in Vedanta Ltd.

Given the heightened regulatory scrutiny and pressure, ANT Group Co is reportedly planning to shift its financial services units into a holding company. These financial services units, which could come under similar regulations and capital restrictions as the banking sector, may include wealth management services, consumer lending and insurance.

Commodities

The commodity index rallied 1.4% last week, rounding off a -3% total return for 2020.
Crude oil rallied by a modest 0.6% last week but has rallied sharply in the early hours of 4 January. Oil has been supported by optimism surrounding vaccine rollout alongside tension in the Middle East. Specifically, aircraft carrier, the USS Nimitz, will remain in the Arabian Sea following threats from Iran.

In agriculture, the sub-index rallied 3.9% last week. This comes on the back of strong rallies in corn (+8.6%); wheat (+1.9%); and soybeans (+4.0%), which are currently trading at 6-year highs. This has been driven by continued Chinese buying as well as fears of dry conditions in South America and the US, which has led to stockpiling throughout supply chains.
In precious metals, gold rallied by 1.4% with silver following suit, rising 3.4%. Both have been supported by the weakest US dollar since 2018 accompanied by higher inflation expectations.

Responsible investments

For the full year 2020, according to Bloomberg, $232.6 billion was issued in Green Bonds across 834 issues, Global Sustainability Bonds totalled $448.3 billion from 1,218 issues and 388 bonds were issued with use-of-proceeds related to the pandemic (a.k.a. Pandemic Bonds). This year could be an even higher year of ESG issuance as governments and corporates aim to put more focus on hitting net-zero carbon goals.

Employees of Google, and parent company Alphabet Inc., have announced this week the creation of a workers union after years of conflict between themselves and management. Previous internal clashes include a dispute against contracts with the military as well as difference in treatment of contract workers. From full-time employees to contractors, all types of employees can join.

Danske Bank has now arranged over $4 billion worth of ESG debt for Nordic borrowers, topping the tables after a record-breaking year for ESG issuance.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

4th January 2021

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	▪ Recent performance is entirely justifiable based on better fundamentals & balance sheets, and the arrival of a vaccine. ▪ Despite this outlook, valuations matter. After a monster month of returns, most spreads are well within long-run average. ▪ We have likely already seen peak liquidity in financial markets. We do not expect material tightening in financial conditions next year, but it is certainly a risk worth watching.	▪ Moving to neutral, risks are two-sided. ▪ A recovering economy propels spreads to all-time tights. ▪ The recovery gets bungled by vaccine delays, geopolitical interruptions, or a limping
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long £ €	▪ Renewed virus concerns and economic disruption to keep nominal growth subdued ▪ Reflation credibility still low, despite Fed framework review ▪ Fed QE and high personal savings underpin demand for treasuries ▪ ECB readying new stimulus effort, while supply declines ▪ Duration remains best hedge for further risk asset correction	▪ Vaccine development pace exceeds expectations, permitting rapid normalisation ▪ Permanent fiscal policy shift rebuilds reflationary credibility ▪ Fiscal largesse steepens curves on issuance expectations ▪ Risk hedge properties deteriorate
Currency ('E' = European Economic Area)	¥ E EM £ Short -2 -1 0 +1 +2 Long A$ $	▪ A Biden presidency should see a weaker dollar through the reduction of trade war risk premium. ▪ Longer term, expensive valuations and twin deficits presage a weaker Dollar	▪ Fiscal gridlock continues in the US, which undermines growth and risk sentiment ▪ Extension of Covid restrictions in Europe and accommodative ECB policy
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	▪ Favourable advanced economy setting support EM assets near term ▪ EM real interest rates relatively attractive, curves steep	▪ Sharp escalation in global risk aversion ▪ EM funding crises drive curves higher and steeper
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	▪ EM economies have been given very long leashes to respond to COVID: deficits and debt have skyrocketed with no plans for reigning them in. Any slowdown will likely exacerbate these 'back burner' issues. ▪ Valuations are still a slight benefit to EM, particularly HY credits. ▪ Low yields, lots of liquidity, and global recovery still could provide tailwinds for EM in 2021.	▪ The USD strengthens. ▪ Growth scars from COVID persist and hurt commodity prices & ability to grow out of deficits. ▪ Governments show little willingness to address deficits post-COVID.
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ IG companies continue to adapt well to the economic environment, given that they are the best-in-class operators in their industries. ▪ Outside of the sectors most affected by COVID, IG spreads are close to all-time tights, and the duration of the asset class has increased 1 full year YTD. Long-end bonds may have more room to flatten, but there is little juice left in lower duration bonds. ▪ The end of the Fed credit facilities has had little impact on the market.	▪ Foreign buyers slow for geopolitical or regulatory reasons. ▪ The cash stockpiles taken out at the depths of the crisis are deployed on large-scale M&A instead of deleveraging. ▪ Yields remain low and TINA (There Is No Alternative) pushes buyers to IG instead of Treasuries.
High Yield Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Spreads are inside LT averages, even adjusting for the better quality of today's index. But higher yields give more cushion than slightly higher quality bonds. ▪ The ability to access financing has dramatically improved the prospects for many companies, especially for COVID-affected industries. ▪ The effects of easy financial conditions hit HY later than higher quality sectors, and tighter conditions will hit HY first.	▪ Prolonged COVID-19 related slump in activity would hurt these companies most. ▪ The sector most sensitive to changing financial conditions. ▪ The combination of policy support, vaccine, positive technical, and economic recovery takes spreads well-inside averages
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Fed buying has overwhelmed highly negative fundamentals for most of 2020, but on-the-run spreads have reached 0. ▪ Fed buying cannot be expected to increase in 2021, exposing negative fundamentals and valuations ▪ Prepays remain and will remain high, with >80% of mortgages having incentive to refinance.	▪ Housing activity slows considerably and prepays move back down to normal levels. ▪ The Fed maintains or increases MBS purchases next year.
Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ RMBS: Housing has been a major outperformer in this recovery, as demand rises and inventory remains low. Strong household balance sheets amongst homeowners has kept fundamentals strong as well. However, many of these bonds are now call-constrained. ▪ CMBS: vaccine news reminded investors that a post-COVID world will exist, and CMBS short covering has been fast & furious.	▪ Changes in consumer behaviour in travel and retail last post-pandemic. ▪ Work From Home continues full-steam-ahead post-pandemic. ▪ Built-up savings from fiscal stimulus/enhanced unemployment benefits are drawn down and mortgage forbearance increases.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper vs Aluminium ▪ o/w Lead vs Zinc ▪ o/w Soybeans vs Corn and Wheat ▪ o/w refining margins (o/w products, u/w Brent)	▪ Oil production disruption

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