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FUND COMMENTARY – Q3 2022

Threadneedle (Lux) European Corporate Bond

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Fund Manager
Since: 01/09/2022

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: iBoxx Euro Corporate Bond Index

Inception Date: 21/09/2018

Fund Currency: EUR

Fund Domicile: Luxembourg

Summary

- The third quarter was a weak period for European corporate credit.
- The fund marginally underperformed its benchmark on a gross basis.
- Tightening monetary policy and slowing economic growth are headwinds, but credit markets are underpinned by solid corporate fundamentals.
- Euro investment-grade credit stands out from its peers in valuation terms.

Market Background

Measured by the fund's benchmark, euro investment-grade (IG) credit returned -3.14% for the third quarter (Q3). This was primarily driven by a sharp rise in the yields on German Bunds, though credit spreads (the gap in yields between corporate and risk-free government bonds) also widened modestly in euro IG.

Core bond yields continued to rise as major central banks grappled with persistent inflation at or close to multi-decade highs in their respective economies. The European Central Bank raised interest rates twice over the quarter, both times by more than expected. A hike of 50 basis points (bps) in July brought rates into positive territory for the first time in eight years, and was followed in September by a further increase of 75 bps. Despite the ECB's efforts, however, on the last day of the quarter Eurostat reported that eurozone annual inflation was estimated to have hit double figures for the first time ever during September.

In the US, meanwhile, hopes of a 'dovish pivot' faded. In September, the Fed released a more hawkish 'dot plot' alongside its third consecutive rate hike of 75 bps. The median projection now signalled a peak interest rate of 4.6% next year, up from 3.8%. This helped push the dollar index to a 20-year high. US GDP was shown to have contracted in Q1 and Q2, but the Fed appears to be more focused on the labour market, which remains buoyant, and – of course – stubbornly high inflation.

Global bond markets were also affected by events in the UK. Investors were unnerved when the new chancellor unveiled a huge programme of tax cuts, unsupported by funding details or by independent projections from the Office for Budget Responsibility. Gilt yields soared, sterling plunged and the Bank of England was forced to buy long-dated gilts to prevent a crisis in the pensions industry.

Credit spreads tightened in July 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. Risk assets have been pressured this year by fears that inflation and monetary tightening might tip major economies into recession, especially those most impacted by the war in Ukraine.

Adding to recession fears, the OECD cut its global growth forecasts. The US economy would grow just 0.5% next year, the group said in September, down from the 1.3% predicted in June. Its projection for eurozone growth next year was slashed from 1.6% to 0.3%, with the German economy shrinking by 0.7%, given its overreliance on Russian gas.

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	09/16-09/17	09/15-09/16	09/14-09/15	09/13-09/14	09/12-09/13
Fund (Gross) %	-15.68	2.31	2.19	6.88	0.50	1.25	7.83	1.02	8.91	5.61
Index (Gross) %	-15.74	1.57	0.23	6.15	-0.03	0.47	7.36	-0.53	7.73	4.32

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.

The past performance information for the period prior to 21 September 2018 is from the European Corporate Bond Fund (a UK authorised UCITS fund launched on 22 October 2002), which merged into this Fund on 22 September 2018.

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 -3.22% for the third quarter compared with the benchmark's return of -3.14%. Interest-rate-related effects detracted slightly as a modestly long duration position (i.e. having more interest-rate sensitivity than the index) and an off-benchmark exposure to sterling bonds proved unfavourable. Industry positioning had a broadly neutral impact: an overweight in utilities detracted while overweights in real estate and consumer non-cyclical added value.

Allocation effects helped performance: the portfolio was a little further overweight in IG credit risk during July's spread-tightening than it was during the September sell-off. Holding some high-yield bonds also helped as spreads tightened in that market. Credit selection was another slight positive: top contributors at the issuer level included Amprion, fellow utilities Vier Gas Transport and Eurogrid, French bank BPCE and logistics-property group P3. Detractors included Sagax, another logistics-property business, alongside grid operators Stedin and RTE.

Activity

We took part in a number of new issues during the quarter, of which the biggest concentrations were in utilities (namely Vier Gas Transport, E.ON, Amprion, National Grid and Alliander) and banking (HSBC, Santander, Credit Agricole, BFCM and Commerzbank). This saw the overweight in utilities increase, though the overweight in banking was reduced as we exited BNP Paribas Crédit Mutuel Arkéa and trimmed other positions in the sector including Belfius, DnB, and Bank of America.

Elsewhere, we increased the small overweight in media by investing in a new issue from Wolters Kluwer (information services) and adding to Netflix. We also marginally increased exposure to basic materials via a new issue from Anglo American.

On the sales side, we lowered the overweights in real estate and healthcare somewhat. In the former, we exited Prologis and Merlin Properties and reduced Digital Realty, while in healthcare we reduced AbbVie, Becton Dickinson and Medtronic. We also moved slightly underweight in financial services – where we exited investment group JAB Holdings and trimmed Berkshire Hathaway – and in telecoms, where we sold out of Vodafone and trimmed AT&T.

More broadly, we modestly narrowed the fund's overweight in credit risk (measured by duration times spread) after July's 'risk on' rally; in terms of sectors, the portfolio remains defensively positioned, with utilities the largest overweight by some distance, followed by senior bank debt.

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. Accordingly, the fund retains an overweight in credit risk, though this is tilted towards defensive sectors that we believe will best weather the current uncertain conditions, such as regulated utilities and senior bank debt.

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.

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.

The fund may invest in the China Interbank Bond Market (CIBM) via Hong Kong Bond Connect which is subject to regulatory, volatility and liquidity risk, as well as risks associated with settlement, default of counterparties and market suspension. Furthermore, the fund may incur significant trading, taxation and realisation costs.

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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