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 – AUGUST 2022

Threadneedle (Lux) European Social Bond

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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

Summary

- The fund's benchmark index returned -4.31% in August.
- Gross of fees, the fund returned -4.54% over the period.
- We bought new green issues from Segro and Bank of Ireland.

Market Background

After a rebound in July, euro investment-grade (IG) corporate bonds posted negative total returns in August, with the fund's benchmark returning -4.31%. The weakness was chiefly driven by core government bond yields, compounded by a widening in credit spreads (the yield difference between corporate and 'risk free' government bonds). The 10-year German Bund yield rose 72 basis points (bps) while spreads in the benchmark index widened by 13 basis points (bps).

Broadly speaking, the first half of the month saw a continuation of July's risk-on rally. Credit spreads tightened alongside further gains in equities. Sentiment was buoyed by a second-quarter (Q2) results season that continued to beat estimates and a surprise fall in the US July inflation print as petrol prices eased. For credit specifically, a seasonal lull in new issuance improved the technical backdrop.

In the second half, however, equities fell, credit spreads widened and core yields continued to soar amid resurgent fears about inflation and central banks' efforts to control it. Hawkish comments from US policymakers stoked concern about what Federal Reserve Chair Powell might say at the Jackson Hole conference near month end. In the event, those hoping for a dovish pivot were disappointed as he reaffirmed commitment to curbing inflation, even at the cost of "some pain" to households and businesses. Credit spreads were also pushed wider as new issuance picked up earlier than expected, particularly in the euro IG market.

In the UK, the Bank of England made its sixth interest-rate hike of the current cycle, which, at 50 bps, was its largest since 1995. It also predicted that inflation would peak at 13.3% in Q4 this year, around which time the UK economy would slump into a prolonged recession. Later, July inflation unexpectedly came in above 10% for the first time in 40 years. UK bonds were further pressured by concern about the programme of tax cuts and borrowing proposed by Liz Truss as she closed in on (and subsequently won) the prime ministership.

The European Central Bank had no rate-setting meeting in August but several of its policymakers said that a 75-bp hike should be on the table for September. Calls for aggressive tightening came despite the flash eurozone purchasing managers' indices falling further into contraction territory. On the last day of the month, the region's August inflation estimate came in at a new record high, adding more pressure on the ECB to act. Meanwhile, Russia ratcheted up Europe's mounting energy and inflation crises by shutting off gas supplies via the Nord Stream 1 pipeline.

Performance

12M Rolling Period Return in (EUR) - as at 31 August 2022

	08/21-08/22	08/20-08/21	08/19-08/20	08/18-08/19	08/17-08/18
Fund (Gross) %	-13.83	1.59	-0.36	7.41	0.10
Index (Gross) %	-13.36	2.07	-1.02	6.92	0.16

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

Sustainability Developments

In ESG news, Australia passed legislation that will introduce two new targets to reduce national greenhouse gas emissions – a 43% reduction in 2005 levels by 2030 and net-zero emissions by 2050. The bill is the most significant development on the climate change front in a decade for Australia, which has long been a laggard. The new legislation will also require key government agencies to incorporate emissions forecasting into investment decisions, while the country's climate minister will present an annual report on progress to parliament.

2022 has been a more subdued year so far in terms of total ESG issuance, given the challenging backdrop. However, the latest data showed that green bond issuance recovered in the second quarter, driven by strong activity in China. Europe has also seen an increase in issuance, notably in France and Germany, though sovereign issuance has remained muted.

Performance and Positioning

Gross of fees, the fund returned -4.54% in August underperforming its benchmark by 24 bps. Credit selection was the main driver of the underperformance. Notable detractors at the issuer level included Wellcome Trust, NatWest and Prologis. Asset allocation and industry positioning had little impact overall; in the case of the latter, overweights in real estate and insurance added value, while the underweight in energy and overweight in banking detracted. Rates strategies were positive in aggregate, mainly due to favourable curve positioning, particularly in the 1–5-year and 25+ year segments.

It was another quiet month for the primary market. We took part in two new green bond issues from property investment company Segro and Bank of Ireland. 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 and subsequently to 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.

In the secondary market, we bought a green bond from Co-operative Bank and added to a number of holdings, including green bonds from the German government and Prologis, along with a social bond from NatWest. On the sales side, we reduced the green bond holdings of real estate firm Digital Realty and Vodafone and sustainability bonds from United Utilities. We also trimmed the exposure to Wellcome Trust.

Outlook

The outlook for IG credit is mixed. Tightening monetary policy is a headwind, albeit one that is already well understood and discounted. We expect that global growth will slow further but avoid an outright recession. This would not be a bad backdrop for investment, as low but positive growth tends to rein in corporate excess without a material rise in default levels. 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 look reasonable but not outstanding in historic terms. While global IG credit spreads finished August over a full standard deviation (SD) above (i.e. cheaper than) the 5-year average, they were only a little above the 20-year average – and even 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 2.8 SDs and 1 SD over 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 neutral-to-slightly-positive outlook on the prospects for 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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