COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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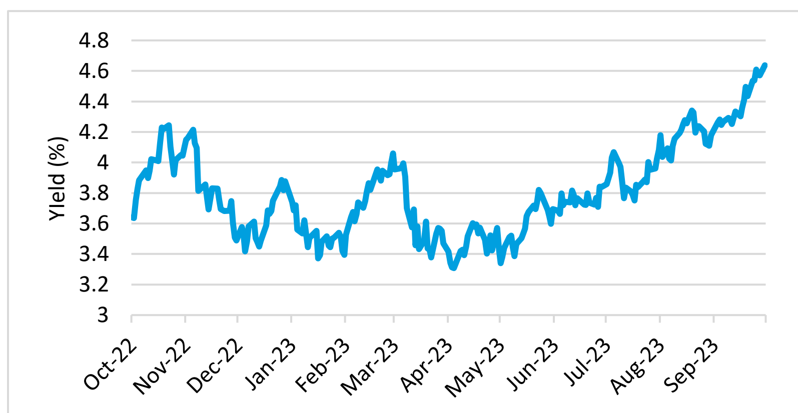
Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	4.62%	19 bps	-3.3%	-1.8%
German Bund 10 year	2.88%	14 bps	-2.3%	-1.2%
UK Gilt 10 year	4.50%	25 bps	-0.8%	-4.6%
Japan 10 year	0.78%	3 bps	-3.1%	-0.5%
Global Investment Grade	134 bps	5 bps	-1.6%	1.0%
Euro Investment Grade	151 bps	5 bps	0.3%	2.3%
US Investment Grade	125 bps	5 bps	-2.7%	0.4%
UK Investment Grade	132 bps	1 bps	2.2%	1.1%
Asia Investment Grade	202 bps	0 bps	-0.7%	2.4%
Euro High Yield	464 bps	20 bps	1.8%	6.3%
US High Yield	403 bps	10 bps	0.5%	6.0%
Asia High Yield	912 bps	-41 bps	-4.5%	-4.7%
EM Sovereign	362 bps	6 bps	-2.6%	1.1%
EM Local	6.8%	11 bps	-3.3%	4.3%
EM Corporate	329 bps	0 bps	-0.3%	3.4%
Bloomberg Barclays US Munis	4.3%	27 bps	-3.9%	-1.4%
Taxable Munis	5.6%	11 bps	-4.9%	-0.1%
Bloomberg Barclays US MBS	66 bps	8 bps	-4.1%	-2.3%
Bloomberg Commodity Index	237.46	-1.2%	4.7%	-3.4%
EUR	1.0555	-0.8%	-3.1%	-1.2%
JPY	149.69	-0.7%	-3.4%	-12.2%
GBP	1.2182	-0.3%	-4.0%	1.0%

Source: Bloomberg, ICE Indices, as of 29 September 2023.

Chart of the week – US Treasury 10-year yield, LTM



Source Bloomberg, Columbia Threadneedle Investments, as of 2 October 2023.

Macro / government bonds

Last week saw further yield curve steepening in core markets in the absence of much in the way of fundamental macroeconomic data.

The market largely attributed this to rising term premia. Although term premia is not directly observable, it is modelled by institutions such as the New York Federal Reserve, which makes its data widely available to the market. Based on the 10-year US tenor, term premia at this maturity point moved from negative to positive at the start of last week. The increase in term premia reflects investors' demand to be compensated for the risk of holding longer-dated securities.

The worsening fiscal outlook in core markets, especially the UK and the US, has raised expectations that interest rates will continue to rise, alongside an increase in interest rate volatility, as governments are forced to expand issuance to meet spending commitments.

There has also been a 'sea-shift' in market dynamics, as central banks have moved from quantitative easing to quantitative tightening measures. The absence of price-insensitive buyers and the unwinding of asset purchase programmes by central banks should continue to put upwards pressure on yields. Previously, the dynamic of central bank buying had helped push term premia into negative territory.

Another factor impacting the rise in term premia has been slowing demand from foreign buyers, such as China, for US treasuries.

While expectations for inflation often intermingle with term premia calculations, last week saw a gentle ebbing in the year-on-year (YoY) changes in inflation, despite the recent climb in oil prices. In the US, headline inflation to the end of August, as measured by the PCE Deflator, rose marginally from 3.3% to 3.5%, while the less volatile core inflation measure, PCE Core Deflator, edged lower from 4.2% to 3.9%. In the eurozone, German headline inflation for the same period fell from 6.4% to 4.3%, while French headline inflation skimmed lower from 5.7% to 5.6%. Allied to the rise in term premia, there was anecdotal evidence of the closure of speculative long positions in core fixed income markets, especially in the UK, as market participants appeared to heed the "higher for longer" messaging from central bankers and cut interest rate risk.

Investment grade credit

The weakness seen in other markets did not go unnoticed in the investment grade field but spread movements have been limited in terms of magnitude. Indeed, a look at spreads over the last couple of months indicates barely a ripply in an otherwise very calm period for credit markets. Year to date, the global index spread is 9% tighter with euro credit 11% tighter and sterling credit 20% tighter – both eclipsing US dollar credit - which tightened in line with the global index.

New issuance had been feared to be very high in September but did not match these expectations, though we note heightened interest in issuing shorter maturity bonds from companies. We suppose that they fear locking in very high (historically) yields for a longer period. This has been primarily a US dollar phenonmenon and has produced a flattening of the US dollar credit curve this year.

Sector wise, and adjusted for duration, media, autos and energy have led the spread tightening while banks, insurers and real estate have been the weakest sectors in 2023.

Looking at yield levels, the global investment grade index yield has popped higher again to 5.6% accroding to data from ICE indices. You would need to go back to October of last year to match that level. The long term average yield is only 4%; so the present level of income offered is attractive in that context. Meanwhile, credit spreads are sitting on the long-term average as they have done for weeks now.

High yield credit & leveraged loans

US high yield bond valuations widened over the week alongside heightened retail fund outflows, equity losses, and a 16-year high for 10-year US treasury yields as investors continue to adjust to the potential for a protracted period of high interest rates. The ICE BofA US HY CP Constrained Index returned -0.45% and spreads were 10bps wider. According to Lipper, retail high yield funds saw $2.4bn of outflows, the largest weekly withdrawal since February. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index saw its largest weekly decline since May, falling $0.25 to $95.56, amidst elevated new issuance and fund outflows. Retail loan fund investors withdrew $356m over the week following four consecutive weekly inflows.

European High Yield (EHY) finished September with a rather lacklustre week as it gave up another 0.25% of performance bringing the month's return to 0.40%. This happened on the back of rising yields (up 14bps to 7.92%) as spreads widened about the same amount to 457bps. The primary market slowed down to €1.7bn after the previous bumper week as only two issuers (PureGym and Piaggio) came to market. This brings September's somewhat disappointing issuance supply to €7.6bn, below the last seven year average. Still, YTD issuance at €46.6bn is double where it was 12 months ago. It was also another week of decompression as CCCs widened 46bps compared to less than 20bps widening in BBs and Bs. Still, the higher beta rating outperformed given its 19% yield, returning 4.5% for September and bringing the YTD performance out of the red. It was a net inflow week as managed accounts saw more money return to EHY overtaking the outflows that continued via ETFs, pushing the latter to price at a discount for much of the week.

It was a busy M&A week with a number of announcements (Ineos buying Eastman's Texas City acetyls site; Cellnex selling stakes in Sweden and Denmark subsidiaries; Altice selling assets in Portugal, DomRep and Israel; and Forvia completing its final asset sale to meet its FY23 plan of €1bn asset disposals).

In sector news, further signs of weakness in the gaming as another company (888) announced a more cautious outlook after the resilient last few years.

In credit rating news, the beleaguered TeleColumbus was downgraded to CCC by Fitch. The rating agency cited, "the company will have a very low margin of safety over the coming months as it continues discussions with creditors and shareholders about achieving a sustainable long-term capital structure." There was better news for Coty, the beauty products firm, which was upgraded to BB by S&P after the issuer raised $350m new equity to be used for debt reduction.

Asian credit

According to Bloomberg, IHC will sell its existing stakes of 1.4% and 1.26% in Adani Green Energy and Adani Energy Solutions respectively to an unidentified buyer. IHC acquired these stakes for around $500m each in 2022. While IHC's decision to exit its investments is surprising given its previous statements that these are long-term strategic investments, other Adani entities continue to get interest from other investors. In August, the Qatar Investment Authority (QIA) acquired a 2.7% stake in Adani Green Energy for around $500m from the promoter family. Additionally, in September, TotalEnergies is reportedly looking to invest $300m for a 50/50 JV with Adani Green Energy.

Adani Ports & SEZ has made a second-round repurchase of the ADSEZ 3.375% '24s bond. With the latest $195m repurchase, the amount outstanding will decline to $325m.

In China, the chairman of China Evergrande Group, Mr Hui Ka Yan has been placed under police surveillance at a designated location. The Chinese authorities are investigating whether he attempted to transfer assets offshore while China Evergrande was struggling to complete unfinished projects.

With regards to ratings action, Moody's downgraded Vedanta Resources to Caa2 (previous: Caa1) and the bonds to Caa3 (previous: Caa2) with a negative outlook. Moody's highlighted the high risk of debt restructuring and limited progress in refinancing its upcoming maturities. On a more positive note, Moody's upgraded Tata Steel to Baa3 (previous: Ba1) to reflect its solid market position and progress in deleveraging.

For China Huarong, Moody's placed its Baa3 issuer rating and Ba1 bond rating under review for downgrade due to its weak risk management and concerns about profitability and asset quality.

Emerging markets

Emerging market hard currency bonds delivered a -1.2% return on the week driven by a combination of modestly rising spreads accompanying rising treasury yields. High yield names delivered the bulk of the spread widening led by African and distressed South American names.

Argentina was one of the worst performers on the week with spreads widening by 181bps to 2539bps. The move coincided with Congress approving a bill that will eliminate income taxes for all citizens making less than x15 the minimum wage. The measure was advocated by economy minister Massa, who is competing with poll leader and far right wing candidate Javier Milei for the upcoming presidential election. The lost tax revenue of this measure risks Argentina's $44bn IMF programme.

In China, the official manufacturing and services PMIs printed slightly stronger than expected. Notably the manufacturing PMI printed in expansionary territory for the first time since March. Less optimistically the Caixin manufacturing PMI survey (which captures smaller and more export-oriented firms) printed much weaker than expectations (at 50.6). A senior analyst at Caixin flagged insufficient domestic demand, external uncertainties and pressure on the job market.

Elsewhere, Hungary and the Czech Republic held rates at 13% and 7% respectively. Thailand surprised the market with a 25bps hike, while Hong Kong delivered a 16th consecutive decline in exports, now printing at -3.7% YoY.

Commodities

The BCOM index delivered a -1.2% return on the week. Industrial metals produced the strongest returns, led by aluminium (+5.3%) and zinc (3.5%) with precious metals selling off by 4.5% on aggregate.

In energy markets, WTI closed the week around flat at $90.8 a barrel. Prices were supported by the news of inventory levels at key storage location Cushing Oklahoma dropping to 22m barrels, which is close to operational minimums.

Responsible investments

Labelled bonds continue to flourish as the total amount issued this year to date stands at $734.4bn, according to Bloomberg.

As noted in the investment grade section, September issuance didn't quite meet expectations; however, interest in this market is certainly present and is on track to exceed the $1trn watermark by the end of the year. As usual, green bonds top the list in most issuance of the four types of bonds (green, social, sustainability and sustainability-linked).

Along with the growing market, comes a growing vocabulary with a recent entry of 'Greenhushing'. A term used to describe financial products in the ESG market that are underselling the 'ESGness' of their asset management. In the same way a fund can be fined or criticised for saying it will do something green and then not, the same fine and criticism can be given to those funds who are far greener than they say they are. Under the SFDR, this would mean an Article 8 labelled fund that should in fact be labelled Article 9 would be accused of 'Greenhushing'. Whilst on the topic of SFDR, earlier in September a public consultation was opened by the European Commission to seek feedback on the current framework as an increasing amount of confusion on the regulation has been raised by the market. Some market players are interpreting from the questions asked in the consultation that the Article 8 and Article 9 labels could disappear and be replaced by a categorisation model, similar to that of the SDR (Sustainability Disclosure Regulation) soon to be released by the UK Financial Conduct Authority.

Fixed Income Asset Allocation Views

2nd October 2023

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	▪ Valuations continue to be rich overall. Technicals seem stable following seasonal issuance; fundamentals show modest pockets of weakness, but no thematic deterioration. **The Group stands neutral on Credit risk overall favouring higher quality credit.** ▪ The CTI Global Rates base case view is no cuts in 2023, with one more possible hike left in the hiking cycle. Focus remains on wages, labor market, financial conditions, and inflation expectations. ▪ Uncertainty remains elevated due to stricter lending, monetary policy tightening, persisting inflation, weakening consumer profile and ongoing geopolitical tension.	▪ Upside risks: the Fed achieves a soft landing with no labour softening, no lasting changes to fundamentals following banking crisis, consumer retains strength, end of Russian Invasion of Ukraine ▪ Downside risks: Rising unemployment, especially if wage growth remains high and the Fed continues hiking. Supply chain disruptions, inflation, volatility, commodity shocks reemerge.
Duration (10-year) ('P' = Periphery)	¥ $ Short -2 -1 0 +1 +2 Long € P £	▪ Longer yields to be captured by long-run structural downtrends in real yields ▪ Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures	▪ Inflationary dynamics become structurally persistent ▪ Labour supply shortage persists; wage pressure becomes broad and sustained ▪ Fiscal expansion requires wider term premium ▪ Long run trend in safe asset demand reverses
Currency ('E' = European Economic Area)	EM A$ Short -2 -1 0 +1 +2 Long ¥ € $ £	▪ Rising expectations around a soft landing and peak Central Bank rates have weakened the dollar ▪ EM disinflation to be more rapid than DM ▪ Drop in global rate volatility supports local flows. ▪ EM real rates relatively attractive, curves still steep in places	▪ Central banks need to keep rates at terminal for much longer than market prices, to the detriment of risk and growth and to the benefit of the Dollar
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	▪ EM central banks slowing or terminating hike cycles ▪ Sharply reduced Fed expectations may permit EMFX strength ▪ EM real interest rates relatively attractive, curves steep in places	▪ Severe US recession and/or financial crisis drives stronger US dollar and portfolio outflows from EMD ▪ Sticky global inflation or wage/ price spiral keeps EM interest rates higher for longer ▪ Structurally higher global real rate environment subdues risk assets
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	▪ EMD spreads 23bps wider than last month, reversing the early summer rally. Technicals are stable but slow. ▪ Conservatively positioned with most idiosyncratic opportunities in lower quality portion of index; prefer local to hard currency. ▪ Tailwinds: Central bank easing in less inflationary countries, IMF program boost for distressed names. ▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, geopolitical risks, domestic political uncertainty.	▪ China/US relations deteriorate; China property sector challenges not contained ▪ Issuance slows ▪ Spill over from Russian invasion: local inflation (esp. food & commodity), slow global growth. ▪ Persisting COVID growth scars hurt economies & fiscal deficits
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ US and EMEA spreads are at similar levels to last month; minor fundamental deterioration at a sector level, but management is positioning conservatively. EUR valuations are attractive; prefer USD and Euro to Sterling. ▪ Typical seasonal issuance to start Sept, but less than estimated and skewed towards the shorter end of the curve. Credit metrics are solid amidst recession uncertainty. Fundamental concerns remain focused on commercial real estate for Banking sector, tight labour supply, changing consumer behaviour.	▪ Costlier funding and tighter lending standards from bank crisis ▪ Volatility remains high and 2023 supply is below expectations. ▪ Market indigestion as central banks sell EMEA corporates ▪ Rate environment remains volatile ▪ Geopolitical conflicts worsen operating environment globally
High Yield Bonds and Bank Loans	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Spreads remain inside historic medians and are roughly unchanged since August. Technicals have been slow but stable, with more issuances in the pipeline. Fundamentals continue deteriorating slightly due to financial conditions, but with no significant impact so far outside of distressed names. ▪ Prefer conservative position; open to attractive buying opportunities in short HY & BB's and higher quality loans where financial conditions are less of a headwind. ▪ US HY defaults remain below historic averages, with further default expectations now being pushed into 2024. ▪ Bank loan market continuing May's rally, with overall market dispersion. Themes: moderating retail fund outflows, delayed defaults, limited issuance, increasing interest burden, credit concern in lower quality loans.	▪ Costlier funding and tighter lending standards from bank crisis ▪ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks ▪ Rising stars continue to outpace fallen angels, shrinking HY market ▪ Rally in distressed credits, leads to relative underperformance ▪ Pockets of weakness improve, HY spreads show resistance to widening that typically follow tightening policy. ▪ Volatility in the short end of the curve, eroding potential upside where we are positioned for carry.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Mortgage index at similar lever to last month with spreads wide of historic medians, the group views agencies as attractive. ▪ Record low real estate transactions leading to low supply of new MBS. ▪ Place to add, prefer high coupon assets; constructive view over longer time horizon.	▪ Costlier funding and tighter lending standards from bank crisis ▪ Rising rates cause prepayments to normalise without reducing mortgage servicing. ▪ Fed continues to shrink position ▪ Market volatility erodes value from carrying
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Our preference remains for quality Non-Agency RMBS ▪ RMBS: Home prices resilient despite headwinds, but with all-time low transaction activity. Delinquency, prepayment, and foreclosure performance remains strong; difficulty seeing deterioration of home prices given labor market strength. ▪ CMBS: We feel cautious, especially on office and multifamily. Delinquencies increasing as maturities come due. Credit curve remains steep. AAAs have mostly retraced post SVB widening, but BBBs remain at widened levels. ▪ CLOs: Pick up in new issuances leading to slightly tightened spreads. Defaults remain low. ▪ ABS: Attractive relval in some senior positions; higher quality borrowers remain stable, lower quality borrowers continue to underperform. Market is active with decent valuations.	▪ Weakness in labour market ▪ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening. Consumer (retail/travel) behaviour fails to return to pre-covid levels ▪ Student loan repayments weaken consumer spreads on a secular level. ▪ Rising interest rates turn home prices negative, denting housing market strength. ▪ Cross sector contagion from CRE weakness.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper ▪ o/w Oil ▪ o/w Grains ▪ o/w Lead ▪ u/w Gold ▪ o/w Zinc ▪ o/w Soybean Meal	▪ Global Recession

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