In Credit

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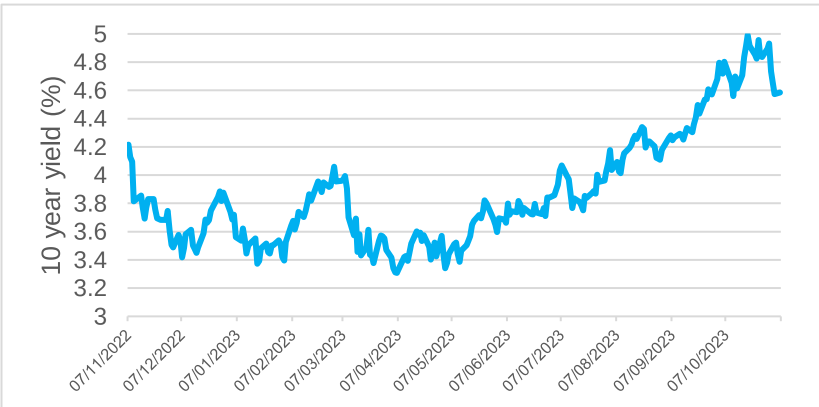
Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.59%	-25 bps	0.6%	-1.2%
German Bund 10 year	2.70%	-13 bps	1.3%	0.1%
UK Gilt 10 year	4.34%	-21 bps	1.4%	-3.2%
Japan 10 year	0.88%	0 bps	-1.5%	-1.9%
Global Investment Grade	137 bps	-3 bps	0.7%	1.8%
Euro Investment Grade	153 bps	-7 bps	1.2%	3.5%
US Investment Grade	129 bps	-2 bps	0.5%	0.9%
UK Investment Grade	132 bps	-4 bps	1.2%	2.4%
Asia Investment Grade	212 bps	6 bps	0.1%	2.4%
Euro High Yield	484 bps	-24 bps	0.6%	6.9%
US High Yield	404 bps	-49 bps	1.1%	7.2%
Asia High Yield	789 bps	-167 bps	-0.4%	-5.1%
EM Sovereign	357 bps	-19 bps	1.1%	2.2%
EM Local	6.7%	-20 bps	2.5%	6.9%
EM Corporate	344 bps	-4 bps	0.0%	3.4%
Bloomberg Barclays US Munis	4.2%	-26 bps	1.0%	-0.4%
Taxable Munis	5.6%	-22 bps	0.0%	-0.2%
Bloomberg Barclays US MBS	60 bps	-17 bps	0.9%	-1.4%
Bloomberg Commodity Index	239.84	-0.3%	0.9%	-2.6%
EUR	1.0749	1.6%	1.5%	0.2%
JPY	149.63	0.2%	0.0%	-12.2%
GBP	1.2423	2.1%	1.5%	2.5%

Source: Bloomberg, ICE Indices, as of 2 November 2023. *QTD denotes returns from 30/09/2023.

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



Source Bloomberg, Columbia Threadneedle Investments, as of 6 November 2023.

Macro / government bonds

Last week was a good week for fixed income with the Bloomberg Global Aggregate Index (in USD Hedged terms) returning 1.4%. What were the catalysts?

First, we had a quarterly refunding statement from the US Treasury on 1 November, where the level of issuance announced was lower than the market had been expecting at $112bn. There was also a twist in the issuance schedule from longer-dated to shorter-dated securities, providing relief at the long end of the US bond market. Previously there had been concern that the US Treasury would continue to ratchet up issuance, especially at the long-end, to cover rising fiscal expenditure. The next day brought the US Federal Reserve decision on interest rates, with rates remaining in a band of 5.25% to 5.5% for the second consecutive month – a 22 year high. Jay Powell, Fed Chair, like other central bankers recently, reiterated a core message that monetary policy had already reached restrictive territory and that we were in a “higher for longer” interest rate environment. He also posed two questions. First, has the Fed done enough? Second, how long should any period of monetary policy restriction last? He also referred to the strength and resilience of the US economy, while stating that a soft landing was its base case scenario. He tried to keep the December meeting on interest rates “live”. However, markets interpreted the Fed’s actions, and Jay Powell’s performance in the accompanying press conference, as indicating a dovish pause, with a high probability that we had reached terminal rate levels, even if the door could not yet be completely closed on monetary tightening. The market received another fillip from much lower than expected labour market data. The Non-Farm Payrolls number for October came in at 150k, in contrast to the previous reading of 336k for September. This fed through to a narrative of a gradually decelerating US economy, which would not warrant further monetary policy restriction.

The Bank of England kept rates on hold at 5.25%, highlighting the absence of economic data that would justify a hike, while it also pointed to an expected deceleration in UK inflation. BoE Governor Andrew Bailey did not rule out the need for further tightening, but remarked that sufficient work had already been done in raising rates, the effect of which would be increasingly felt in the real economy. From a market standpoint, last week saw a break in the recent yield curve steepening trend, as yield curves in core markets flattened. Is this the inflection point? There is still not enough data for either the market or central banks to claim this definitively, but we are close to one.

Investment grade credit

The pause in interest rate hikes (US and UK) and the anticipation of easier monetary policy next year provided a solid boost to credit markets last week.

One investment bank descibed the last five trading days as a ‘powerlift’ in terms of buying interest and after more muted client interest in October. This saw credit spreads tighten – led by CDS indices but also notably in more liquid cash bonds. Investors seem keen to ‘lock in’ higher yields before interest rates fall and as such these yields remain elevated. Spreads are presently in the middle of the 2023 range having started the year at around 147bps and ending last week at 137bps. The peak in spreads this year came during the SVB/Credit Suisse banking turmoil earlier this year at 170bps. The recent rally has been led by corporate issuers with banking spreads lagging ahead of expected higher levels of new issuance especially in the US dollar market.

In specific news, auto giant BMW reported strong margins and results against a tough market background of higher interest rates, declining demand and heightened inflation. Apple’s share price fell following results, despite a slight beat in terms of earnings and revenue coming in line. The market has reacted poorly to Apple’s disappointing holiday outlook, revenues continuing to decline, and weakening performance in China. In China, Apple face tensions with Huawei and the government (who banned iphones within government) alongside poor consumer sentiment. Meanwhile, IAG (British Airways+) was upgraded by Moody’s to Ba1 from Ba2, taking the composite rating to BB+ in line with rival Lufthansa. Both are seeking a return to the investment grade market.

High yield credit & leveraged loans

US high yield valuations tightened sharply amid a collapse in interest rates and generally better than feared initial earnings reports.

The ICE BofA US HY CP Constrained Index returned 2.74% and spreads were 50bps tighter. Despite the rally, retail high yield bond fund outflows totalled $953m, an eighth consecutive weekly outflow. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index lagged the fixed income rally, decreasing $0.04 to $94.80. Retail loan funds saw a $126m inflow, the first inflow in six weeks.

It was a strong week for European High Yield as it returned +1.23% with spreads narrowing -23bps, to 484bps. Yields fell 35bps to 7.91%, supported by a fall in underlying government bond yields. BBs and Bs strongly outperformed CCCs (by almost 3x) as decompression continued. This was even with another week of outflows (€101m), albeit lighter from the previous one, with funds exiting via ETFs and managed funds. The corporate primary market remained quiet last week with only a €500m hybrid from APA Infrastructure (Australian utility). Last week's market rally helped October close with only a small loss for the month (-23bps).

In sector news, last week's Q3 earnings reports showed continued weakness in cyclical sectors (e.g. chemicals, construction, consumer durables) on the back of continued customer destocking. Auto sector reports were more mixed with continued demand but as some companies withdrew guidance for 2023 (e.g. Ford) while the travel and leisure sector picture remained strong (e.g. British Airways, Lufthansa).

In positive credit rating moves, Ford was upgraded to investment grade (in spite of withdrawing its outlook guidance) by S&P to BBB-. S&P cited an expectation of EBITDA margins to exceed 8%, significant liquidity to absorb any cyclicality and disruption, and that cost reduction will more than offset increased labour costs over the next 24 months. Given that Ford already has an IG rating from Fitch, it will leave the high yield universe in November. In airlines, British Airways (IAGLN) was upgraded to Ba2 by Moody's while Lufthansa was upgraded to BBB- by Fitch.

In M&A news, the Telecom Italia story looks like it is finally coming to a close as its board approved the sale to KKR.

Finally, another large potential strike (just as the UAW and Hollywood writers' strikes are coming to a close) as 35,000 Las Vegas hospital workers announced they will walk off on 10 November if a labour contract is not settled by then.

Asian credit

According to Chinese Finance Minister Lan Fo'an, China will accelerate the issuance and use of government bonds. The Finance ministry will steadily push for the resolution of local government debt risk to leverage the role of special bonds to boost the economy. This ties in with the recently-announced desire of central government to use its fiscal balance to support the local governments with an additional CNY1trn of CGB issuance (China Government Bonds).

Foreign direct investment (FDI) in China, as measured by the direct investment liabilities in its balance of payments, fell by $11.8bn in Q3. This is the first time the FDI measure has turned negative since records started in 1998 and underscores the lower willingness of foreign companies to re-invest their profits in the country. The key drivers were the more attractive investment opportunities elsewhere, given higher interest rate as well as geopolitical tension.

San Miguel Corp signalled continuing support for its subsidiary SMC Global Power (SMCGP). According to the CFO, the parent company San Miguel Corp is reviewing a range of options to help SMCGP call the perpetual security in April 2024 ($783m SMCGL 6.5% perpetual).

Emerging markets

The EMBI Global index delivered a 2.85% total return. This was due to spreads tightening by 19bps alongside falling US treasury yields, which coupled with higher duration (at 6.36) meant emerging market debt outperformed.

On the data front, we got the Chinese Caixin PMI’s that told the same story as the official releases, both services and manufacturing were modest misses, with services in slight expansion and manufacturing in mild contraction. We also had several Q3 GDP releases, Hong Kong printed at 4.1% y/y vs expectations of 5.2% with Taiwan marginally beating expectations at 2.3% y/y. In Europe, Poland printed at 1.9% vs 2.3% in Q2 and the Czech Republic delivered larger contraction than expected at -0.6%. Mexico’s GDP printed marginally ahead of expectations at 3.3%.

In credit rating news, Costa Rica was upgraded by Moody’s from B2 to B1, following progress on fiscal consolidation and strengthening debt management capabilities. Costa Rica was also recently upgraded to BB- by S&P. Elsewhere, Egypt was downgraded to B- from B by Fitch. This downgrade follows risks to external financing, macro instability and a slow progress on reforms such as the transition to a flexible exchange rate policy.

In Thailand the government is taking measures to improve tourism, including the scrapping of visas for visitors from India and Taiwan until May 2024. This follows the recent scrapping of visas for Chinese nationals. Thailand will also be extending the opening hours of entertainment venues in tourist cites until 4am.

Commodities

The BCOM index delivered a -0.3% total return. Energy was the sole negatively contributing sub-sector at -2.5%, this was partially offset by gains in industrial metals (+1.1%) and softs (+1.9%).

Brent prices climbed down from $90.5 to $84.9 following Iranian backed militant group Hezbollah said it had no knowledge of the 7 October attack on Israel, bolstering hopes that the war will be contained. Prices rallied on Thursday following the weaker US jobs report and ensuing US dollar weakness, and was trading higher on Monday following the news of Saudi Arabia and Russia holding firm on their previously announced supply cuts.

Base metals have broadly been supported by the news of China stepping up its use of debt to spur growth alongside a recent pledge to resolve local authority debt risks. Iron ore has rallied 10% in the last two weeks and is trading close to March highs. Iron is supported by being a likely beneficially of Chinese infrastructure spending alongside a sharp fall in inventory levels at Chinese steel mills. Nickel rallied 2.1% following the news of Nyrstar closing two of its mines on the back of falling metal prices and rising production costs. Nickel prices are down 41.6% YTD.

Finally in grains Ukraine reported total grain exports dropping 32% y/y due to the suspension of the Black Sea grain export deal earlier this year. Wheat prices are down 33.6% YTD.

Fixed Income Asset Allocation Views

6th November 2023

COLUMBIA THREADNEEDLE INVESTMENTS

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 but have cheapened in the past month. Technicals seem stable; fundamentals show modest pockets of weakness but no thematic deterioration. **The Group stands neutral on Credit risk overall upgrading High Yield and Structured 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 geopolitical tension, stricter lending, monetary policy tightening, persisting inflation, and weakening consumer profile.	■ Upside risks: the Fed achieves a soft landing with no labour softening; consumer retains strength; end to Ukraine and Israel-Hamas wars. ■ Downside risks: Fed is not done hiking and unemployment rises. Another banking crisis, this time from unrealised losses on securities and CRE, supply chain disruptions, inflation, volatility, commodity shocks re-emerge.
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.	■ 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	■ Disinflation under threat but intact; EM central banks still in easing mode. ■ Real yields remain high. ■ Selected curves continue to hold attractive risk premium.	■ Sustained high core rates thwart EM easing cycles. ■ Energy persistence derails disinflation trend. ■ US outperformance strengthens US dollar. ■ 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 30bps wider than last month, reversing the early summer rally. Technicals are slower, outflow and weak issuance. ■ Conservatively positioned with most idiosyncratic opportunities in lower quality portion of index, focus on relval opportunities. ■ Tailwinds: Central bank easing in less inflationary countries, potential China stimulus, IMF program boost for distressed names. ■ Headwinds: higher debt to GDP ratios, wider fiscal deficits, geopolitical and domestic political uncertainty, restructurings slow.	■ China/US relations deteriorate. ■ Issuance slows. ■ Spill over from Russian invasion and Israel-Hamas war: 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 have widened since last month. Fundamentals are in focus as earnings report. Global portfolios prefer EUR IG over USD on relval basis. ■ Fundamental concerns remain focused on commercial real estate and unrealised losses for banking sector, tight labor supply, changing consumer behaviour.	■ Lending standards continue tightening, even after Fed pauses hiking cycle. ■ Rate environment remains volatile ■ Mass layoffs spike, worsening consumer profile. ■ Geopolitical conflicts worsen operating environment globally
High Yield Bonds and Bank Loans	Under-weight -2 -1 0 +1 +2 Over-weight	■ The group upgraded HY as prices have fallen, while technical and high-quality HY fundamentals remain stable. Financial conditions continue to punish destressed names. ■ Conservatively positioned, but open to attractive buying opportunities in short HY, BBs and higher quality loans. ■ US HY defaults remain below historic averages, with greater default expectations for 2024. ■ Bank loan market has been more volatile in the past month. Themes: moderating retail fund outflows, delayed defaults, improving CLO issuance, increasing interest burden, credit concern in lower quality loans.	■ Lending standards continue tightening, increasing the cost of funding. ■ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks ■ Rally in distressed credits, leads to relative underperformance ■ 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. ■ Supply is manageable as higher rates and fall seasonals kick in. ■ Performance has been driven by the Fed's hiking cycle, with MBS widening into a bear steepener. ■ Place to add, prefer high coupon assets; constructive view over longer time horizon.	■ Lending standards continue tightening even after Fed pauses hiking cycle. ■ Prepayments normalise as rates rise 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	■ Upgraded outlook because of decent risk-adjusted valuations in select high quality Non-agency RMBS, CLOs and ABS. ■ RMBS: September saw spreads widen, attractive risk-adjusted valuations. Home prices resilient despite headwinds. Delinquency, prepayment and foreclosure performance remains strong. Expect fundamentals to hold in as long as labor market strength remains. ■ CMBS: The group is cautious, especially on office and multifamily, however non-office sectors perform as expected. Delinquencies increasing as maturities come due. Credit curve remains steep. ■ CLOs: Spreads softer in past month. Defaults remain low but CCC buckets continue to rise slowly. ■ ABS: Attractive relval in some senior positions. Higher quality borrowers remain stable, lower quality borrowers underperform. Student loan repayments restart, with 12 month ramp up period.	■ 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 profile more than anticipated, affecting 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 Grains ■ u/w Gold ■ o/w Soybean Meal ■ o/w Oil ■ o/w Lead ■ o/w Zinc	■ Global Recession