In Credit

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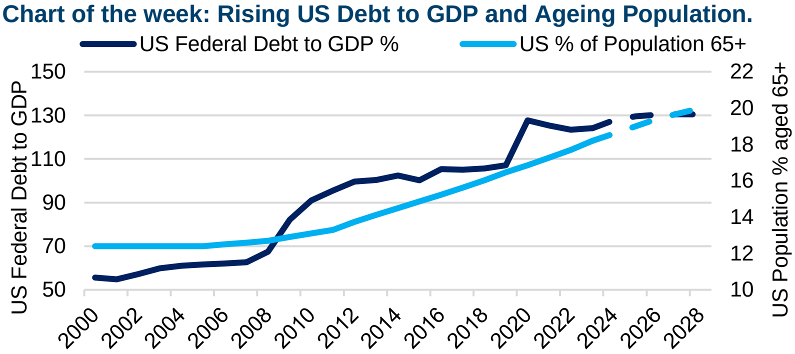
Born in the US*AA+*

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	4.07%	12 bps	-1.0%	0.6%
German Bund 10 year	2.59%	9 bps	-0.8%	0.3%
UK Gilt 10 year	4.43%	11 bps	-0.1%	-3.9%
Japan 10 year	0.63%	6 bps	-2.3%	0.3%
Global Investment Grade	131 bps	2 bps	-0.1%	2.6%
Euro Investment Grade	148 bps	1 bps	0.8%	2.8%
US Investment Grade	122 bps	3 bps	-0.5%	2.7%
UK Investment Grade	130 bps	-1 bps	1.8%	0.7%
Asia Investment Grade	199 bps	2 bps	0.0%	3.1%
Euro High Yield	462 bps	16 bps	1.0%	5.4%
US High Yield	401 bps	19 bps	0.8%	6.3%
Asia High Yield	881 bps	42 bps	-1.6%	-1.8%
EM Sovereign	348 bps	9 bps	0.3%	4.2%
EM Local	6.4%	5 bps	1.1%	8.9%
EM Corporate	334 bps	4 bps	0.7%	4.4%
Bloomberg Barclays US Munis	3.7%	23 bps	-0.9%	1.8%
Taxable Munis	5.2%	6 bps	-1.8%	3.1%
Bloomberg Barclays US MBS	55 bps	7 bps	-0.9%	0.9%
Bloomberg Commodity Index	237.96	-1.1%	4.9%	-3.2%
EUR	1.1004	-0.1%	0.9%	2.8%
JPY	141.95	-0.4%	1.8%	-7.5%
GBP	1.2782	-0.8%	0.4%	5.5%

Source: Bloomberg, Merrill Lynch, as of 4 August 2023.

Chart of the week: Rising US Debt to GDP and Ageing Population.



Source: U.S. Census Bureau, United States Office of Management and Budget and Columbia Threadneedle Investments, as of 07 August 2023.

Macro / government bonds

Not quite so AAA anymore. Fitch, the credit rating agency, downgraded the long-term credit rating of the US from AAA to AA+. The rating agency pointed to the triple whammy of rising interest rates, the lack of a medium-term fiscal framework, and an ageing society **(see chart of the week)**. The level of general government debt to GDP for 2023 has now reached 113%, significantly in excess of the AAA median of 39% for Fitch's ratings. Fitch argued that the US continues to benefit from a large, well-diversified, high-income economy, as well as the US dollar's status as a preeminent reserve currency. Moody's now remains the only credit rating agency to continue to confer on the US its top rating of Aaa. Alongside the ratings news, the US Treasury boosted the size of its quarterly sale of longer-term debt, for the first time in more than two years, from $96bn to $103bn, exerting upward pressure on bond yields. While issuance provided a technical reason for higher yields, fundamental data gave little real respite.

The quaintly named measure of US labour market strength, Non-Farm Payrolls, came in lower than expected at 187K (versus expectations of 200K), while the unemployment rate edged lower to 3.5%.

The steepening of the US treasury curve was reflected in both the eurozone and UK bond markets. In the UK, the Bank of England raised interest rates by another 0.25% to 5.25% and released its latest projections for the UK economy, which saw inflation falling back to 2% by 2025, due to increasing economic slack in the economy. Although the market continued to price in terminal rates of around 5.7% for the UK, Governor Andrew Bailey made the point that a further rate rise was not a done deal. At the accompanying press conference, he posed the question that all central bankers are struggling with – how quickly persistent components of inflation will fall back across the economy and whether underlying inflationary pressures will continue to persist even as headline measures fall. In a three-way split, the majority of rate-setters voted to ratchet rates higher, justifying their decision on upside surprises on wage growth and the underlying resilience of the UK economy.

Investment grade credit

It was a slow week in European investment grade credit last week with four straight days of no new issuance – as expected with it being peak results season and the beginning of the summer holidays for many Europeans. It was a different story in the US where $19.5bn was priced across the asset class on Monday alone (according to Bloomberg).

Results generally have been strong so far with Amazon delivering strong sales numbers in Q2 and rumours of a return to an IG rating for Rolls Royce after strong H1 results. Elsewhere, Apple reported weak iPhone sales numbers.

Spreads were marginally flat to a few basis points wide, on the week in most regions, with the UK going against the grain and ending the week 1bps tighter.

High yield credit & leveraged loans

US high yield bond valuations widened modestly over the week amidst an active new issue market and generally satisfactory initial Q2 earnings reports. The ICE BofA US HY CP Constrained Index returned -0.40% and spreads were 18bps wider. According to Lipper, retail high yield funds reported a $1bn outflow, the fifth outflow over the last six weeks. Similarly, the average price of the J.P. Morgan Leveraged Loan Index declined -$0.15. Retail loan funds saw a $278m outflow, the largest outflow since May.

It was a week of consolidation with modest negative returns (-0.08%) as European High Yield (EHY) gave back some, both in spread (+16bps to 462bps) and yield (+16bps to 7.76%). Flows were also negative as flows into ETFs and short duration funds only partially offset the outflows from managed accounts. Still, July overall saw an inflow of some €400m, taking the YTD inflow to just over €1bn. At the same time, last week saw the return of compression as CCCs strongly outperformed higher rated credits (BBs and Bs had modest negative returns versus the positive performance of CCCs). The primary market remained shut for the summer holidays but with talk of issuance waiting in the wings.

Earning results were the focus of last week with packaging firms (eg, Ball, Sappi), confirming they are experiencing some destocking, with global shipment volumes down 4.5%. Still, there is talk of a steady recovery in shipments that should be constructive for improvement in the second half of this year. This was in contrast to travel related firms (eg, Dufry, Lufthansa, WizzAir) who announced better than expected results and, in some cases, raised their guidance for 2023. This came on the back of good underlying travel momentum and margins which are coming ahead of previous guidance. In telecoms, there was a positive surprise from Telecom Italia which posted small positive growth in revenue and EBITDA (+0.5%) after 21 quarters of decline. Altice also had solid earnings news, beating expectations, showing that EBITDA and free cash flow rose 7% and 13%, respectively. This was good news and a welcome relief given the recent volatility surrounding corruption charges on Altice Portugal individuals and entities. In credit rating news, Moody's upgraded Renault to Ba1 from Ba2 citing "continued improvement in profitability, driven by positive pricing and product mix effects." Moody's also referenced the repayment completion, in the H1,2023, of the French State guaranteed loan.

JPMorgan published its calculation for EHY default, as of end of July 2023, at 2% with Casino behind the jump from the previous default figure of 1.35%. This is due to JPMorgan's different calculation methodology of default as Casino has still not officially been declared at default (rating continues to be at C by both Moody's and S&P) and remains in market indices. JPMorgan also reported a sharp decline in recovery rates (34%) down from 72% a year ago. It was noted that market dispersion has increased with only 25% of bonds trading between 500bps and 1000bps compared with 40% in April 2022.

Structured credit

The US Agency MBS market suffered alongside all other bond sectors as rates sold off and spreads widened. The sector underperformed the broad high-quality market, posting a loss of -81bps on the week. As it relates to Fitch's downgrade of US treasuries from AAA to AA+ it is important to note that agency MBS are not rated securities, unlike agency debentures. MBS are primarily backstopped by US homeowners and the government guarantee only comes into play when homeowners default. The consensus view is for minimal impact of MBS spreads as a result. Also of note is that in the wake of the S&P downgrade in 2011, many investment mandates today do not reference a AAA percentage requirement. Rather, many guidelines have been adjusted to refer to the asset class themselves as a permissible investment (US treasuries, Agency MBS, etc), rather than explicitly stating a requirement for AAA government debt. As a result, we have not seen forced selling related to the news. Attractive relative value coupled with low supply remains a positive technical.

CMBS spreads tightened last week, extending a multi-week rally. AAA bonds are seeing robust demand and attractive valuations in lower dollar price, lower in the stack bonds are attracting PE buyers. While the office sector remains in the headlines industrial and multi-family sectors are well-bid.

Asian credit

On 1 August, China's National Development and Reform Commission (NDRC) pledged to increase credit to private companies and extend other funding measures to small firms. The pledge includes the expansion of a bond credit enhancement tool that is backed by financial institutions to all qualified private companies. Additionally, the PBOC held a meeting with several private developers (Longfor, CIFI holdings, Midea) to discuss the funding challenges in the economy albeit without many details as regards any material support at this point.

Ambuja Cement (63% owned by the Adani family) announced the first major acquisition by an Adani entity this year. Ambuja Cement will acquire the 56.74% stake of Sanghi Industries Ltd (SIL) from the existing promoter group for an Enterprise Value of around $605m. This purchase will enable Ambuja Cement to increase its cement capacity to 73.6mtpa (currently: 67.5mtpa).

Vedanta Resources Ltd (VRL) sold a 4.3% stake in Vedanta Ltd for $500m, reducing its shareholding to 63.8%. VRL has also rolled over the inter-company loans ($450m) by one more year to December 2024, albeit at a much higher interest rate of 17%. VRL will continue to rely on more dividend payments from Vedanta Ltd to manage its high near-term debt maturity.

Delhi International Airport made a tender offer for the INAPIN 6.25% '25s, which highlights that the onshore borrowing environment in India continues to be supportive for companies to refinance their more costly US dollar borrowings.

Emerging markets

Emerging market hard currency debt delivered a -1% return on the week with spreads widening by just shy of 9bps.

Notable data points of the week included: Turkish CPI printing ahead of expectations at 47.8% y/y, Egypt hiking its deposit rate 100bps (despite expectations of a hold) and Indonesia's GDP beating expectations (of 5%) at 5.17% y/y.

In South America there was further rate cutting, with Brazil lowering the Selic rate by 50bps (more than expected) to 13.25%. It was agreed that a 50bps pace would be appropriate, going forward, according to the published central bank statement. The central bank expects CPI to hit 4.84% this year versus the 3% target, which is only expected to be reached in 2025. This follows Chile cutting rates by 100bps last month.

In the distressed space, Kenyan spreads widened 35bps on the week as Moody's flagged that the government's planned buy-back of $1bn worth of the nation's 2024 notes may constitute a default if they are redeemed below par. Kenya is currently engaging with the IMF. It had to request additional funds in December following the worst drought in a decade.

Commodities

The BCOM index delivered a -1.1% return on the week with weakness in grains (-7%) and precious metals (-1.6%) more than offsetting the rally in energy (+1.2%).

Grains saw price support from Russian bombings damaging port infrastructure and thousands of tonnes of grain in Ukraine. Ukraine also stepped-up attacks of Russian ships and ports. This was outweighed by upwardly revised crop expectations from France and Ukraine, with Ukraine revising its wheat forecast to 20.2mt from 17.9mt following improving weather and yields.

In Crude, Brent rallied 2.2% on the week, finishing at $86. Prices were supported by the further extension of Russian and Saudi voluntary production cuts to September. OPEC+ also reported it was happy with compliance of output levels (which isn't always a given). In the US, the EIA reported weekly US crude inventories dropped by a record 17m barrels, taking inventories 1% lower than average for this time of year. Finally, crude prices were supported by the supply risk of Ukraine declaring Russian Black Sea ports as at war risk. Black Sea routes account for 15-20% of Russian crude exports.

In precious metals, gold declined by 1.2%. Given 2023's relative outperformance, the gold index is now up 3.2% YTD against a -3.2% total return for the BCOM index. Speculators are still net long in gold but have been trimming their bets for the past two weeks. Gold demand has been bolstered by record central bank buying this year; China raised its gold reserves for a ninth straight month with total stockpiles now 2,137 tonnes.

Responsible investments

German automaker BMW is investing more than originally planned into its development of electric vehicles as strong quarterly figures resulted in increased sales forecasts into next year. The most popular i4 sedan and iX3 SUV models made up most of the 13% in EV sales in the first half of 2023, which is set to increase to at least one fifth next year. Logistical problems for certain components and increased costs may slow things down somewhat, but the focus is on meeting the increasing customer demand.

Another regulation may be on the horizon for the UK as the Department for Business and Trade has announced it is considering a UK Sustainability Disclosure Standards rule book for 2024. The reporting rules will be closely based on the International Sustainability Standards Board (ISSB), a regulation adopted by only a handful of nations so far and will allow close comparison to reporting standards globally on ESG issues.

Fixed Income Asset Allocation Views

7th August 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 have tightened recently but remain wide of February's market. Technicals have stabilised, fundamentals remain a headwind. **The Group stands neutral on Credit risk overall favouring higher quality sectors.** ▪ The Fed Funds market is pricing in a peak of 5.4% and rates being cut to 5.4% in 2023. This market has been volatile, with the first full cut not priced until 2024 ▪ The CTI Global Rates base case view is no cuts in 2023, with one or two more cuts before holding to the end the year. Focus remains on wages, financial conditions, and inflation expectations. ▪ Uncertainty remains elevated due to pullbacks in lending surrounding banking crisis, monetary policy schedules, recession probabilities, persisting inflation, weakening consumer profile and ongoing geopolitical tension.	▪ Upside risks: the Fed achieves a soft landing with no labour softening, banking crisis eases with no lasting changes to fundamentals, consumer retains strength, end of Russian Invasion of Ukraine ▪ Downside risks: additional bank failures, simultaneous low unemployment, high inflation, hiking and slowing growth cause a recession. Russian invasion spills into broader global/China turmoil. 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 continue tightening, with destressed credits leading the rally. Technicals have stabilised. ▪ Maintaining conservative positioning, opportunities at idiosyncratic level, but 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 reopening stall. ▪ 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 have tightened since last month; with fundamentals mixed versus pre-COVID. EUR valuations are cheap, prefer USD and EUR to sterling ▪ YTD net issuance greater than last year, held back most by financials, but expect to pick up in 2H23. Focus on earnings, and gauging credit metrics admid recession uncertainty. Fundamental concerns remain focused on commercial real estate for Banking sector, tight labour supply, weaker consumer, recession concerns.	▪ 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 continue to tightening with valuations inside historic medians. Unchanged fundamentals and technical ▪ Prefer conservative position while open to attractive buying opportunities, especially in short HY & BB's. ▪ US HY defaults higher than last year but still at reasonable levels, possibly normalising to historic trends. ▪ Bank loan market has widened along with other credit sectors. Themes: retail fund outflows, rising defaults, limited issuance, 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
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Mortgage index tightening from last month but remain wide of historic levels, the group sought to capitalise recent outperformance. ▪ Supply below expectations from rates but improving with seasonals. Liquidation of failed banks better than feared. ▪ Place to add, prefer high quality and higher coupon assets; constructive view over longer time horizon	▪ Costlier funding and tighter lending standards from bank crisis ▪ Housing activity slows and rising rates move prepays to normal levels without hurting mortgage servicing rates ▪ Fed continues to shrink position
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. Delinquency, prepayment, and foreclosure performance remains strong; need labor market weakness to see housing deterioration. Risk premiums still cheap to LT avg. ▪ CMBS: We feel cautious, especially on office and multifamily. Credit curve is very steep; non-office sectors remain stable. Delinquencies increasing as maturities come due and floating rate debt becomes more expensive. ▪ CLOs: Spreads have tightened since June. Downgrades outpacing upgrades. More tail risks for subordinate bonds. 2023 supply estimate revised lower. ▪ ABS: Attractive relval in some senior positions; higher quality borrowers remain stable. Market is active	▪ 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 ▪ Rising interest rates dent housing market strength and turn home prices negative in 2H23. ▪ 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 ▪ u/w Silver ▪ u/w Gold ▪ o/w Lead ▪ o/w Soybean Meal	▪ Global Recession