COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

10 July 2023

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General Fixed Income

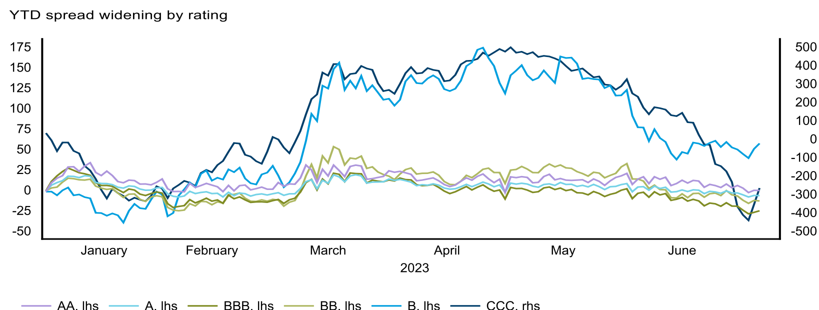
The importance of earning interest.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	4.07%	23 bps	-1.3%	0.4%
German Bund 10 year	2.65%	26 bps	-1.5%	-0.3%
UK Gilt 10 year	4.69%	30 bps	-2.2%	-6.0%
Japan 10 year	0.46%	6 bps	-0.2%	2.5%
Global Investment Grade	137 bps	-3 bps	-1.0%	1.7%
Euro Investment Grade	155 bps	-6 bps	-0.5%	1.5%
US Investment Grade	128 bps	-2 bps	-1.3%	1.9%
UK Investment Grade	142 bps	-4 bps	-1.0%	-2.0%
Asia Investment Grade	193 bps	-9 bps	-0.4%	2.7%
Euro High Yield	460 bps	-2 bps	-0.2%	4.2%
US High Yield	408 bps	3 bps	-0.6%	4.8%
Asia High Yield	817 bps	25 bps	-1.6%	-1.7%
EM Sovereign	363 bps	0 bps	-1.2%	2.6%
EM Local	6.4%	5 bps	-0.4%	7.4%
EM Corporate	337 bps	-7 bps	-0.5%	3.1%
Bloomberg Barclays US Munis	3.6%	6 bps	-0.3%	2.3%
Taxable Munis	5.3%	20 bps	-2.0%	3.0%
Bloomberg Barclays US MBS	55 bps	3 bps	-1.4%	0.4%
Bloomberg Commodity Index	228.35	0.5%	0.5%	-7.3%
EUR	1.0957	0.5%	0.5%	2.4%
JPY	142.49	1.5%	1.5%	-7.8%
GBP	1.2814	1.1%	1.1%	6.3%

Source: Bloomberg, Merrill Lynch, as of 7 July 2023.

Chart of the week: Emerging Markets – Spread changes by rating



Source: Macro bond, Columbia Threadneedle Investments, as of 10 July 2023.

Macro / government bonds

The week saw a spike in volatility in sovereign bond markets on stronger than expected US data. Yields were much higher by the end of the week.

US data had initially been weaker with a further decline in the ISM manufacturing index, a broad gauge of activity in the US economy, from 46.9 to 46 while US factory orders fell from 0.4% to 0.3%. This fed through to a market narrative that the US Federal Reserve's efforts were starting to have some success in dampening demand. The widely anticipated release of the Fed minutes, which were meant to provide light on why the FOMC had skipped a rate hike when its own projections to a median interest rate of 5.6% by the end of the year, was greeted hawkishly by the market. This reflected news of a split within FOMC voting members, with some favouring a 0.25% hike in June, justified by labour market tightness and unexpected momentum in the global economy. The following day US treasury yields, and by extension global bond yields, received an unexpected boost from the ADP employment report. The report, which covers 25 million Americans, stated that the US economy had gained 497K jobs versus expectations of 225K, largely due to jobs gains in consumer-facing service industries. This enhanced market concerns that the Fed had more work to do.

Although the NFP report is widely regarded as having less informational power than the ADP report, there is a skittishness in markets as we traverse the final length to terminal rate levels. The NFP report, although weaker at 209K was regarded as solid, cementing the path to a further rate hike in July. The UK gilt market sold off on the US data. The UK clearly has a sticky inflation problem, while Christine Lagarde, President of the European Central Bank, warned in a press interview that there would be further work to do, especially if wages and profit margins continued to increase. The more inflationary tone to data in the US led to bear steepening generally, as long-dated interest rates rose faster than short-dated interest rates. The benchmark 10-year instrument in the US, Germany, and the UK rose by around 20bps in a nervy week for government bond markets.

Investment grade credit

The market has been on a very gradual spread tightening trajectory these past weeks.

Global IG spreads, which reached 170bps over government bonds at one point in March of this year, have squeezed into a spread of less than 140bps – and close to the long run average. The tightening has been led by cyclical sectors such as media, autos, industrials and basic materials. But the rally has been widespread and all sectors - even banking - at tighter spread than the end of 2022. Lower quality credit including BBB rated bonds and high yield have also outperformed on a risk-adjusted (%) basis this year compared to AAA, AA and A rated debt.

We have been in lull in terms of corporate results and last week began with US Independence Day, which meant that markets were seasonally quiet even as we go into the summer lull.

We see buyers supporting the market at these higher yield levels into the month end / new quarter.

Troubled UK utility giant Thames Water, juggling a high debt load and the shock departure of its CEO, will present results today followed by an investor presentation. Positive noises from the UK government suggest that government support is only a remote possibility / necessity. These two news pieces have supported bond prices after recent underperformance.

High yield credit & leveraged loans

US high yield bond spreads oscillated over the week amid an increasingly hawkish central bank narrative.

The ICE BofA US HY CP Constrained Index returned -0.58% while spreads were effectively unchanged. According to Lipper, retail high yield bond funds saw a $283m outflow for the week. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index rose $0.21 to a high since April 2022 with 46% of the Loan index now trading above $99. The loan asset class is benefiting from a higher-for-longer Fed policy narrative, a resilient economy, more balanced retail fund flows, and a more-than-decade low pace of new supply. Retail loan funds saw a $53m outflow for the week.

It was a busy week for European High Yield (EHY) as the primary market saw €1.75bn (four new issuers) come to the market. New issues, all single B rated, were well taken by the market with pricing generally coming at the lower end of price talk, even inside of price talk, in some cases. Returns were moderately negative (-20bps) for the first week of July, despite the modest tightening of spread (-2bps to 460bps) as underlying government bond yields rose on the back of increased expectation of more rate hikes, causing EHY credit yield to rise 11bps to 7.97%. Market avoidance of CCCs and distressed debt was, again, apparent as CCCs severely underperformed BBs and Bs, returning -1.5% for the week. In a change from the last few months, sterling high yield outperformed EHY, returning +30bps. There were modest positive flows into the asset class, largely due to ETFs but also some into short duration high yield.

In M&A news, Teva announced it is considering selling its API business (the building block for generic medicine production) for $2bn. The company wants to focus on development rather than on generics.

In restructuring news, there were improved rescue offers for Casino, the French retailer. Kretinsky's plans looks better, at the moment, with more new equity (€1.5bn) and gross debt of €2.2bn while the French group's offer stands at €0.9bn in new equity and debt of €3.5bn.

Structured credit

Mortgages underperformed quality fixed income last week. Wider spreads and higher interest rates weighed on the sector and combined for a total return of -1.44%. Market volatility ramped with stronger than expected payrolls sending rates significantly higher. Lower coupons with less duration outperformed. The FDIC has now sold about 70% of mortgages assumed from the failed banks, a good forward looking technical for supply volumes. Also, to note, prepayments in June were up marginally due to seasonals (1 less day count). In CMBS, trading was light on the holiday week. Weekly rating actions continue to be negative with two bonds upgraded and nine downgraded. Activity in ABS is expected to pick up this week. Spreads were relatively flat week over week.

Asian credit

In China, the PBOC has imposed restrictions on domestic banks from buying bonds issued in Free Trade Zones (FTZ). The government is concerned that low-quality LGFVs (Local Government Financing Vehicles) have been excessively issuing FTZ bonds as an alternative funding channel. LGFVs have resorted to issuing more FTZ bonds amid the difficulty in printing conventional onshore bonds and offshore bonds. According to Bloomberg, Chinese property companies are planning the issuance of state-guaranteed bonds after a two-month respite. Country Garden was the last issuer of state-guaranteed bonds in May 2023.

The Hong Kong Monetary Authority (HKMA) has issued guidelines to banks for the adjustment of countercyclical macroprudential measures for property mortgage loans. This is the first time the HKMA has eased the macroprudential measures for residential properties since these were implemented in 2009. Following the latest adjustments, homebuyers will be able to obtain property mortgages loans at a higher LTV (loan-to-value ratio), which could potentially entice first-time buyers and home upgraders. For example, the maximum LTV ratio for mortgages has been raised from 50% to 70% for homes that are valued up to HKD15m (around $1.9m).

The competitive intensity in the India mobile telecom sector is set to increase with Reliance Jio's launch of affordable phones. The Jio Bharat phones are specifically targeted for feature phone users who are currently using 2G and voice services. Beta trials commenced on 7 July. Jio is aiming to gain new subscribers from India's 2G/voice segment by offering an attractive plan for the transition from 2G/voice-only to 4G data.

The Adani family is reportedly looking to sell Adani Capital, one of its non-core businesses, for around INR20bn. The potential bidders include Bain Capital, Carlyle Group and Cerberus Capital Management, according to Bloomberg.

In Thailand, the selection of the new Prime Minister will be held on 13 July. The new PM has to secured at least 376 votes, which represents more than half of the 750 members of the lower and upper houses of parliament.

Emerging markets

A week of two halves in emerging markets as we saw the rally in lower quality issuers continue **(see chart of the week**), led by the likes of Pakistan and Sri Lanka following recent positive stories. Spreads in distressed names have tightened considerably recently, taking emerging market hard currency spreads to YTD tight levels. Later in the week we saw the same names struggle, as well as high beta African names. Consequently, spreads ended in the same place they started at 363bps. Flat spreads and higher US treasury yields resulted in a negative return over the week of -1.20%.

In ratings news, Thailand and Hungary were both affirmed at BBB+ and BBB- (respectively).

In China, inflation printed at much weaker than expected. CPI rose 0% YoY vs expectations of 0.2%. PPI declined by 5.4% YoY vs expectations of a shallower 5% decline. Chinese PPI (MoM) has now printed at zero or below for every month of the year with CPI (MoM) printing negative for every month since January. There is now concern businesses and consumers will defer purchases causing a deflationary spiral. The market awaits more substantial easing following lacklustre support so far in 2023.

The government have taken two key (but likely insufficient) actions. Firstly, purchases for the state pork reserves will be boosted in attempt to put a floor on prices that have declined 7.2% YoY. Secondly, financial institutions will be encouraged to extend outstanding loans to property developers to ensure the delivery of homes.

Commodities

The BCOM index rallied by 0.5% on the week with strength in energy markets (+2.0%) being offset by weakness in grains (-0.6%).

WTI rallied by 4.2% closing the week at just shy of $74 a barrel. This followed the US announcing the purchase of another 6m barrels of crude to refill the strategic petroleum reserve. This takes yearly purchases to 12m barrels following a 180m drawdown last year.
In OPEC+ news, Saudi Arabia announced the extension of its 1m barrel per day production cut from July to August, and Russia announced a 500k per day cut in exports next month.

Responsible investments

For many of us, the last few weeks have meant BBQs in the garden, a few more freckles and generally enjoying a hot summer. It is, however, totting up to be the hottest summer on record. Last week the average worldwide temperature was broken three times in only seven days. A new record of average worldwide temperature of 17.23C was reached on Thursday, according to records from the Climate Change Institute, having beaten the previous 17.18C set on Tuesday. The month of June was also the warmest for 30 years. Green bond issuance 'should' be helping fund projects to curb climate change, but several market players are calling for more clarity and transparency on green bond proceeds as challenges arise when assessing exactly where the financing is going and its progress. Thankfully, green bond issuance is increasingly a focus for many issuers, with total issuance YTD of $300bn+ a sign of that.

Fixed Income Asset Allocation Views

10th July 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 have tightened recently but remain wide of February's market. Technicals have stabilised, fundamentals remain a headwind. **The Group leans negative on Credit risk overall favouring higher quality sectors.** ▪ The Fed Funds market is pricing in a peak of 5.3% and rates being cut to 5.0% in 2023. This market has been volatile, with the first full cut now priced for Nov. ▪ The CTI Global Rates base case view is no cuts in 2023, and possibly one more hike during the summer. Expect the Fed to hold steady in 2H 2023. Focus remains on wages, financial conditions, and inflation expectations. ▪ Uncertainty remains elevated due to fears surrounding banking crisis spill over, 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)	¥ (-1) $ (+1) Short -2 -1 0 +1 +2 Long P (-1) £ € (+1)	▪ 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$ (0) Short -2 -1 0 +1 +2 Long €$£ (0)	▪ 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 (+1) Under-weight -2 -1 0 +1 +2 Over-weight C (0)	▪ 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 beginning to tighten from March wides.. Technicals remain weak ▪ Maintaining conservative positioning while open to select idiosyncratic or relval based buying opportunities. ▪ Tailwinds: Central bank easing in less inflationary countries. ▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, increasing use of IMF programs, geopolitical risks, domestic political uncertainty.	▪ China/US relations deteriorate; China reopening less stimulating than hoped. ▪ Issuance slows ▪ Chinese reopening paused ▪ 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 spreads have tightened & EMEA spreads unchanged since last month; Fundamentals and Technicals still weak to pre-COVID. EUR valuations are cheap, prefer USD and Euro to Sterling ▪ May issuance mostly in longer end of curve. Earnings resilience with deteriorating credit metrics point to idiosyncratic opportunities. Fundamental concerns remain focused on commercial real estate for Banking sector, tight labour supply, weaker consumer, recession concerns.	▪ Additional bank failures with too little governmental intervention ▪ Volatility remains high and 2023 supply isbelow 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 have tightened since early May, fundamentals and technical remain unchanged, with beginning of June reversing May outflows. ▪ 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	▪ Additional bank failures with too little governmental intervention. ▪ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks ▪ Rally in distressed credits, leads to relative underperformance
Agency MBS	Under-weight -2 -1 0 +1 ■+2 Over-weight	▪ Mortgage index remain wide to historic levels, the group sought to capitalise on Mya's weakness. ▪ Supply below expectations but improving. FDIC liquidations from Banks nearly half done. ▪ Place to add, prefer high quality and higher coupon assets; constructive view over longer time horizon	▪ Additional bank failures ▪ Housing activity slows and rising rates move prepays to normal levels without hurting mortgage servicing rates ▪ Fed continues to shrink position even as hiking is paused
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 remain 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 ▪ CLOs: Spreads have widened slightly since May. Downgrades outpacing upgrades. More tail risks for subordinate bonds ▪ 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 ▪ WFH continues in 2023 (positive for RMBS, negative for CMBS). ▪ Rising interest rates dent housing market strength and turn home prices negative in 2023 ▪ 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 Wheat ▪ o/w Soybeans ▪ o/w Corn	▪ Global Recession

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