COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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All quiet on the credit front.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	4.30%	12 bps	-1.7%	-0.1%
German Bund 10 year	2.64%	9 bps	-0.9%	0.3%
UK Gilt 10 year	4.48%	5 bps	-0.2%	-4.1%
Japan 10 year	0.71%	8 bps	-2.4%	0.3%
Global Investment Grade	133 bps	0 bps	-0.4%	2.3%
Euro Investment Grade	152 bps	-2 bps	0.7%	2.8%
US Investment Grade	123 bps	1 bps	-1.1%	2.1%
UK Investment Grade	134 bps	2 bps	1.9%	0.8%
Asia Investment Grade	203 bps	-6 bps	-0.2%	2.9%
Euro High Yield	457 bps	-10 bps	1.7%	6.2%
US High Yield	385 bps	4 bps	1.4%	6.9%
Asia High Yield	943 bps	-18 bps	-3.8%	-4.0%
EM Sovereign	352 bps	3 bps	-0.5%	3.3%
EM Local	6.5%	8 bps	-1.8%	5.9%
EM Corporate	331 bps	-3 bps	0.4%	4.0%
Bloomberg Barclays US Munis	3.8%	5 bps	-1.3%	1.3%
Taxable Munis	5.3%	4 bps	-2.3%	2.6%
Bloomberg Barclays US MBS	54 bps	0 bps	-1.7%	0.1%
Bloomberg Commodity Index	239.83	-0.5%	5.6%	-2.6%
EUR	1.0725	-0.7%	-1.9%	0.0%
JPY	146.96	-1.1%	-2.4%	-11.3%
GBP	1.2504	-1.0%	-1.8%	3.2%

Source: Bloomberg, Merrill Lynch, as of 8 September 2023.

Chart of the week – Global IG Corporate Bond Spread – LTM

Source: ICE Indices and Columbia Threadneedle Investments, as of 11 September 2023.

Macro / government bonds

There have been two opposing narratives at play in macro markets.

One has been that we are on the cusp of terminal rates with the rate cutting cycle likely to begin in early 2024. The other has been the "higher for longer" narrative, in which rates remain at a higher level for a longer period of time.

The markets seemed to tilt closer towards the "higher for longer" narrative following stronger than expected Institute of Supply and Management (ISM) data, which provides a read on US economic growth. The broad ISM services Index rose to a six-month high of 54.5 from 52.7. Other ISM readings on employment, prices paid, and new orders all increased likewise to higher levels. The data outturns matter as a tight US labour market should continue to exert upward pressure on wages, and thereby inflation.

The relative resilience of the US economy at this stage in the tightening cycle has raised the bar towards any shift to easier monetary policy. John Williams, New York Fed president, commented that US monetary policy was in a good place, but that policy makers would have to "parse" through economic data to decide on the best way to proceed with monetary policy. Raphael Bostic, Atlanta Fed president, reiterated his position that the economy is slowing and that we have yet to see the lagged impact of past rate hikes. Reflecting the "higher for longer" narrative, 2-year US treasury yields rose 0.11% to the cusp of 5% while 10-year yields rose 0.09% to 4.26%.

One consequence of the "higher for longer" narrative has been 'greenback' strength against a basket of major currencies. The Japanese yen skirted close to 150, prompting Bank of Japan policy member, Juncko Nakagawa, to state that current monetary policy remained appropriate. A major issue that the Bank of Japan faces is that many in the market disagree with this line of thinking, pointing to higher levels of imported inflation and the potential for increased tension with trading partners, such as China and South Korea.

European markets largely took their cue from the US despite uncertainty over whether the European Central Bank will continue to raise interest rates in the face of a rapidly slowing eurozone economy. Andrew Bailey, Governor of the Bank of England, appeared before a parliamentary committee on monetary policy. He raised themes common to all the major central banks bar Japan: the shift to data dependency; the risk of overtightening; and the amount of transmission yet to come from past monetary policy decisions. While a more dovish presentation of the central bank's position allowed bonds to rally at the front end of the gilt market, valuations of longer-dated gilts continued to weaken, as markets eyed another theme common to all major markets: the steady increase in issuance as governments pay for fiscally expensive policies that were designed to combat Covid and the inflationary impact of the war in Ukraine. All this at a time when central banks have stepped away as price insensitive buyers of government debt, pointing to steeper yield curves across major markets.

Investment grade credit

An eerie calm has fallen upon the credit market **(see chart of the week).**

In spite of a 'return to school' deluge of primary market activity last week the spread offered on the global corporate bond index remains lodged at 133bps according to data from ICE indices. While the range of this spread has been between 127bps and 170bps this year, the more recent one month range has been only around three basis points. As mentioned last week, contextually spreads are very close to both shorter-term (five year) and longer-term (20 year) spreads. It has also been a very light period in terms of company news.

Markets remain supported by strong corporate health and an improvement in the economic outlook (according to consensus expectations). Likewise, expectations suggest we are close to the end of this cycle of monetary policy tightening. Rates are now restrictive and are expected to remain so for the foreseeable future. Valuations, as mentioned, are close to short and long

term norms. It might be worth noting that prolonged periods of low volatiliy have preceded 'sell offs' in the market including the calm of 2003-2007 and more recently in 2021. Early days to make such a call but worth monitoring.

High yield credit & leveraged loans

US high yield bond yields rose sharply while spreads widened modestly over the week alongside rising rates amid data that indicated a resilient US economy. The ICE BofA US HY Cash Pay Constrained Index returned -0.30% and spreads were 5bps wider. According to Lipper, retail high yield bond funds saw a $252m inflow. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index continued to rise, increasing $0.12 to $95.55 with the asset class benefitting from elevated yields and modest fund inflows. Retail loan funds saw their seventh weekly inflow over the past year with a small $97m contribution.

The European High Yield (EHY) market rebounded last week with spread tightening 12bps, back to 455bps, though yields remained basically unchanged at 7.74%. Flows were still net negative (-€146m), solely due to outflows from managed accounts as ETFs experienced small inflows over the week. September opened with a bang for the corporate primary market with four new issues, all broad BB, one of which is a new issuer to the market (Boels, a Dutch rental equipment company), for a total of just over €2bn. Bonds were well received, largely trading inside the initial price talk and well in the secondary market. Interestingly, one is a green bond (ZF) while Rexel is a sustainability-linked bond. Exceptionally, three out of the four were new money, which has been a change from this year's general trend of refinancings.

The latest rising star in the EHY market is Ford. Fitch upgraded Ford's rating to BBB-, citing expectation that EBIT and FCF margins as well as leverage will be stronger than earlier expected by Fitch. It is interesting that this announcement comes before negotiations on pay between the auto workers' union (UAW) and the major car manufacturers has been settled and given the potential of a strike. The UAW is demanding a 46% wage increase and has already rejected Ford's initial offer of a 15% raise.

There was good news from Altice as the Drahi, the major shareholder of the French telecom, made clear that everything and anything is up for sale. The French paper, Les Echos, reported that Altice is close to selling data centres in France.

Securitised credit

A shorter week meant less data and lighter activity in Agency MBS. The broader rate sell-off left the sector in the red by 33bps. 15-year MBS outperformed 30s and higher coupons outperformed lower as a result. Agency MBS spreads have tightened since their mid-August wides but remain cheap on a historical basis. Fortunately rate volatility has fallen but remains elevated as the market awaits further clarification on the Fed's plan – how high and how long. August prepayment speeds increased 7% for 30-year Fannies and 6% for 15 years. Non-agency trading volumes picked up alongside risk with spreads mostly tighter 5-25 bps.

The CMBS new issue market remained quiet, with no deals pricing since 22 August. Secondary benchmark CMBS spreads were mostly unchanged on light trading and lack of new issuance. The downgrade trend continued with just one deal upgraded and seven deals downgraded.

Asian credit

Country Garden averted a default on its offshore bonds by paying a combined $22.5m of coupons on two US dollar bonds, just before the 30-day grace period expired on 5 September 2023. Additionally, it has also received sufficient support from bondholders to extend the payment on CNY3.9bn of onshore bonds to 2026. Over the coming week, the company faces two important deadlines. Country Garden is seeking an extension of maturity for around CNY10.8bn of onshore bonds and the creditors' vote for this extension will end on 11 September. Furthermore, the company is looking to get an extension for CNY1.435bn of notes, which are puttable on 14 September.

SK Hynix stated that it has not been engaged in business transactions with Huawei since the onset of US sanctions on the latter. SK Hynix is investigating how its memory chips are being used in Huawei's latest smartphone (Mate 60 Pro).

Pertamina Geothermal is reportedly looking for a potential $1bn ESG loan that is priced at below 100bps over the SOFR (Secured Overnight Financing Rate). The company is also reportedly in negotiations to acquire a geothermal asset owned by KS Orka Renewables for as much as $1bn.

Emerging markets

Emerging market hard currency bonds posted a negative return over the week of -0.47% as US treasury yields moved higher, detracting from EM returns. The high yield sector outperformed investment grade with gains coming from the single B and below rated bucket.

In Nigeria, the opposition party's motion to oust President Tinubu on election malpractice was overturned.

In Mexico we got news of the latest budget. This included an estimated fiscal deficit of 4.9%, the highest since 1988, driven by rail projects, social programmes and growing support for state owned oil company Pemex.

In Europe, Poland delivered a 75bps rate cut overshooting expectations of a mere 25bps cut. Critics branded the decision as political, as part of an effort to boost the economy ahead of upcoming elections.

Finally, Turkey had its credit rating outlook upgraded to stable by Fitch. President Erdogan also reaffirmed his support for higher interest rates to fight inflation alongside a pledge to maintain fiscal discipline.

Commodities

The BCOM index delivered a -0.5% total return with industrials and precious metals selling off by 3.0% and 2.3% respectively.

Crude oil continued its recent rally with brent climbing 2.4% on the week and is trading at $90+ at the time of writing. Prices were supported by Saudi Arabia extending its existing 1m barrel per day cuts until the end of the year and Russia extending its 300k barrel per day export cuts over the same period. Saudi Arabia is aiming to boost its current oil revenues to diversify away from oil, while state-owned oil company Saudi Aramco is also looking to undergo a secondary share offering.

Fixed Income Asset Allocation Views

11th September 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 (■: 0)	▪ Valuations have continued to tighten, some sectors their richest in over a year. Technicals seem stable; 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 hike before holding to end the year. 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 (¥: -1; $: +1; P: -1; €: +1; £: +1)	▪ Longer yields to be captured by long-run structural downtrends in real yields ▪ Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures	▪ Inflationary dynamics become structurally persistent ▪ Labour supply shortage persists; wage pressure becomes broad and sustained ▪ Fiscal expansion requires wider term premium ▪ Long run trend in safe asset demand reverses
Currency ('E' = European Economic Area)	Short -2 -1 0 +1 +2 Long (EM, A$: 0; ¥, €, $, £: 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))	Under-weight -2 -1 0 +1 +2 Over-weight (R: +1; C: +1)	▪ 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 (■: -1)	▪ EMD spreads have widened in the last couple of weeks, however technical still remain balanced with limited supply over the last couple of months. ▪ Conservatively positioned with fewer idiosyncratic opportunities after market compression, 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 (■: 0)	▪ US and EMEA spreads have tightened since last month; with fundamentals showing resilience, minor exceptions in consumer facing names and some energy and utilities. EUR valuations are cheap, prefer USD and Euro to Sterling. ▪ YTD net issuance greater than last year, and expected to pick up in 2H23. Confidence from credit metrics amidst 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 (■: -1)	▪ Spreads continue to tightening with valuations inside historic medians. Technicals strong and stable, fundamentals still solid but beginning to show small pockets of weakness. ▪ Prefer conservative position while open to attractive buying opportunities, especially in short HY & BB's and higher quality loans where increased financing costs are less of a headwind. ▪ US HY defaults higher than last year but still at reasonable levels, possibly normalising to historic trends. ▪ Bank loan market continuing May's rally, with overall market dispersion. Themes: 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.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight (■: +2)	▪ Mortgage index unch or slightly wider than last month with spreads wide of historic medians, the group views agencies as opportunistic. ▪ 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 ▪ Market volatility erodes value from carrying
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight (■: 0)	▪ 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. ▪ 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. ▪ CLOs: Continued modest tightening. Downgrades outpacing upgrades. Prefer new issues, but supply is low. ▪ ABS: Attractive relval in some senior positions; higher quality borrowers remain stable. 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 ▪ 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 (■: 0)	▪ o/w Copper ▪ o/w Grains ▪ u/w Gold ▪ o/w Soybean Meal ▪ o/w Oil ▪ o/w Lead ▪ o/w Zinc	▪ Global Recession

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