In Credit

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David Oliphant
Executive Director,
Fixed Income

Contributors

David Oliphant

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Angelina Chueh

Euro High Yield Credit

Chris Jorel

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Laura Reardon

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Kris Moreton

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Justin Ong

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Charlotte Finch

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Jake Lunness

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Sarah McDougall

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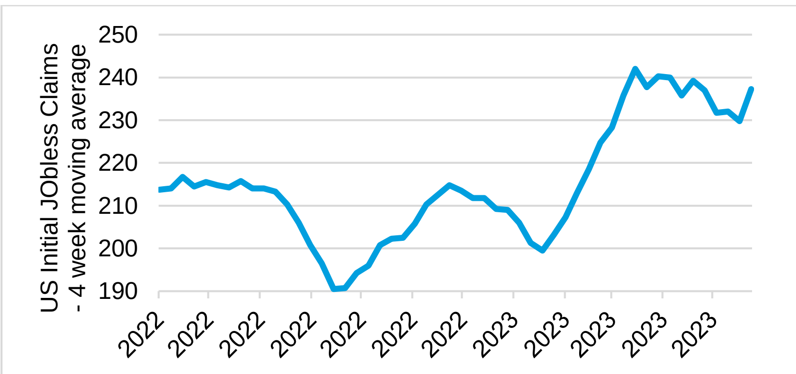
Unemployment trending higher

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.75%	6 bps	-1.2%	1.8%
German Bund 10 year	2.39%	7 bps	-0.3%	1.2%
UK Gilt 10 year	4.28%	12 bps	-5.5%	-3.4%
Japan 10 year	0.43%	2 bps	0.1%	2.5%
Global Investment Grade	147 bps	0 bps	-0.4%	2.4%
Euro Investment Grade	162 bps	-5 bps	0.7%	2.3%
US Investment Grade	140 bps	1 bps	-0.8%	2.6%
UK Investment Grade	141 bps	-3 bps	-2.2%	0.1%
Asia Investment Grade	207 bps	-3 bps	1.0%	3.3%
Euro High Yield	465 bps	-22 bps	1.8%	4.8%
US High Yield	429 bps	-8 bps	1.2%	4.9%
Asia High Yield	778 bps	-43 bps	-2.2%	0.6%
EM Sovereign	382 bps	-6 bps	0.4%	2.6%
EM Local	6.3%	-8 bps	2.0%	7.3%
EM Corporate	360 bps	-8 bps	0.8%	3.1%
Bloomberg Barclays US Munis	3.6%	-1 bps	-0.6%	2.1%
Taxable Munis	5.0%	4 bps	-0.9%	4.5%
Bloomberg Barclays US MBS	54 bps	-3 bps	-0.5%	2.0%
Bloomberg Commodity Index	224.07	1.2%	-3.4%	-8.5%
EUR	1.0783	0.4%	-0.8%	0.4%
JPY	139.26	0.4%	-4.7%	-5.9%
GBP	1.2591	1.0%	1.9%	4.0%

Source: Bloomberg, Merrill Lynch, as of 9 June 2023.

Chart of the week: US Jobless Claims – 4 week moving average – LTM



Source: Bloomberg, Columbia Threadneedle Investments, as of 12 June 2023.

Macro / government bonds

Yields increased across developed market government bonds, with the UK 10-year seeing substantial increases of 12bps to 4.28%.

On Tuesday, the Reserve Bank of Australia delivered a surprise 25bps hike with the committee flagging that inflation may have passed its peak, but indicators still point to persistent inflation. The largest increase in yields happened on Wednesday, coinciding with the Bank of Canada's (BoC's) also delivering a surprise 25bps hike. This was surprising as the BoC has held policy rates since January, with the bank citing the pick-up in the housing market and tight labour market conditions driving more persistent excess demand. The BoC also alluded to more hikes in the future. Expectations for the US Federal Reserve's Thursday meeting are for a "hawkish hold", leaving the door open for future hikes as committee members take time to evaluate the impact of previous tightening.

On the US data front, initial jobless claims rose to 261k, much higher than expectations of 235k **(see chart of the week)**. The represents a spike higher from the recent trend in claims and is welcome news for the US Federal Reserve. We also had the UK REC jobs report, which showed the supply of workers is increasing at its fastest pace in two and half years (+156k). The report also showed an uptick in firms citing redundancies and a slowdown in hiring, alongside the number of pay rolled employees dropping by 136k.

In Europe, Germany's manufacturing PMI fell to a three year low at 43.2. German factory orders delivered a substantial miss, declining by 0.4% vs expectations of a 2.8% increase, thanks to a decline in large scale orders. Manufacturing has been consistently weak in Europe, with consumers prioritising service spending.

Investment grade credit

Global credit spreads were little changed last week with spreads ending the period at around 147bps. Market volatility has been noticeably lower since the conditions seen in March. Current spreads are in the middle of the 2023 range of 127-170bps, according to data from ICE indices.

From a longer-term perspective this place global investment grade credit spreads at around 0.5 standard deviations (SDs) cheap to the last five years average spread and around 0.1 SDs above the 20-year equivalent. That latter number is slightly lower if we adjust for the deterioration in credit market quality over the last couple decades. This year, on a sector-by-sector basis banking spreads (6% wider), real estate (4.6%) and insurance (3.5%) have been the weakest sectors while media (-6%) and autos (-5%) have pulled in the opposite direction. These spread moves are adjusted for the various durations of the sectors.

With the earnings season largely behind us there was little idiosyncratic news to focus upon last week while new issuance continues to tick along at a healthy rate.

High yield credit & leveraged loans

European High Yield (EHY) had another positive week with falling yields (-11bps to 7.65%) and tightening credit spreads (-22bps to 465bps) even as underlying government bond yields rose. Compression continued with CCCs outperforming higher rated credits and EHY outperforming sterling high yield. Flows were subdued but positive (+€56m), led by ETFs with managed accounts experiencing inflows for short-dated EHY and as part of global high yield strategies. The primary market was also subdued with only one new issuance for B rated Infopro Digital across two bonds (€975m). There was good demand with the final offering price coming in well within the initial price talk.

In rating changes, downgrades seem to be picking up. This week, SBB, the Swedish real estate group, was downgraded again, this time to BB- by S&P, with negative outlook. Synthomer, the chemical company, was downgraded by Moody's, to Ba3 from Ba2 on the back of a lower outlook. In the previous week, there were five downgrades (TeleColumbus, Softbank, Canary Wharf, Asda, and Catalent) and only one upgrade (Cirsa).

In M&A news, the drama at Casino, the beleaguered French retailer, continues. TERACT announced they have pulled out of merger talks with Casino but this was quickly followed by Auchan news that they have taken up merger discussions with Casino. In the background, bond restructuring talks continues with existing bond holders while the offer by entrepreneur Daniel Kretinsky to inject €1.1bn into the operations remains on the table. Telecom Italia saga also continues this time with two new offers, for their fixed network business (KKR and consortium with Macquarie).

Structured credit

The US Agency MBS market was up 4bps outperforming the broader high quality bond market. The FDIC has now sold off approximately 35% of the Agency MBS securities acquired from the failed banks with strong demand from institutional buyers. Spreads continued to tighten but remain cheap on a historical basis. In Non-agency, new issuance was very light and secondary trading declined again. CRTs are performing well as spreads tighten on reduced supply and strong performance. In CMBS, concerns remain elevated specifically for the office sector. While delinquencies are rising, we are now just back to April 2022 levels in Conduit CMBS. That said, over the last two years delinquencies averaged 48 loans per month, while 72 loans fell delinquent in May 2023. The office segment is seeing the sharpest increase. Another sector to watch is the ABS market where we are seeing a bifurcation of performance across consumers profiles. Lower fico renters in unsecured consumer loans and subprime auto delinquencies are up while higher fico and prime auto remains stable. Expect more pressure as student loan payment deferral programmes end in August as a result of the debt ceiling negotiation.

Asian credit

In China, the large banks have reduced the deposit interest rates by around 5-15bps, part of the measure to drive spending. The deposit rate cuts also indicate that the PBOC may proceed further by reducing the benchmark lending rates (medium-term lending facility rate) and guiding the LPR (loan-prime rate) lower. The inflation data (core CPI and PPI) remained soft in China, which highlights the weak economic momentum in May. The CPI inflation rose 0.2% y/y in May, in line with consensus while PPI inflation fell 100bps to 4.6% y/y, more than consensus.

The Adani Group has reportedly revived its investment plans for the Mundra PVC project (total cost of INR350bn) and it has received in-principal approval for a INR140bn credit line from several banks. Earlier in March, the Adani Group suspended the project in light of funding uncertainty on the back of the short-seller allegations about governance and weak financial transparency.

TSMC indicated that its 2023 capex budget will be towards the bottom of its guidance of $32-36bn (2022 capex: $36.2bn). The inventory digestion and recovery in end-demand are taking longer than expected.

Emerging markets

The EMBI Global index delivered a 0.32% total return last week.

Turkish inflation cooled to 39% y/y from 44% previously alongside India's CPI moderating to 4.25%. Furthermore, India's composite and services PMI printed at 61.6 and 61.25 respectively. In central bank news, Russia, Poland, India and Peru all held rates, with Serbia opting for a 25bps hike to 6.25%.

In Turkey, President Erdogan hired ex-Goldman Sachs banker (Erkan) as head of the central bank; Erdogan's second ex-Wall Street addition to his team. This market is interpreting this as a precursor to the return of conventional economics following Erdogan's track record of firing central bank heads who raise rates too much. The Turkish lira continued its fall to all-time lows of 23.5 vs the US dollar, in anticipation of FX support being removed. Elsewhere, Turkey's stock market rallied to all-time highs (in local currency).

Nigerian 10-year spreads tightened by 50bps in response to President Tinubu suspending the central bank governor for "investigate reasons". Investors saw this a signal that Nigeria will also be returning to economic orthodoxy, with the governor's current policy of a complex multiple exchange rate regime deterring international investment. According to a member of Tinubu's advisory board the unification of the exchange rate regime in now "imminent". This follows the removal by Nigeria of an expensive fuel cost subsidiary, a substantial drain on government finances.

Commodities

The commodity index rallied by 1.2% with Industrial metals (+1.2%) and agriculture (+3.0%) delivering the largest returns.

Industrial metals were mainly supported by rallies in copper (+1.7%) and zinc (4.5%). Zinc has been one of the weaker performers in the index (-18.7% YTD) and has been adversely impacted by the disappointing recovery in China's real estate sector (due to its uses in galvanising steel). Last week, Citigroup said a major turnaround in Chinese steel demand was unlikely due to the absence of a strong property rebound. Elsewhere, Goldman see persistent problems in the Chinese real estate sector mainly related to lower tier cities and developer financing.

Fixed Income Asset Allocation Views

12th June 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 widened since the last meeting: still cheap relative to Feb but tighter than March's highs. Technicals and fundamentals are still worse than Feb. The group remained negative on credit risk but upgraded investment grade credit to neutral. ▪ The Fed Funds market is pricing in a peak of 5.1% and rates being cut to 4.4% in 2023. This market has been volatile, with the first full cut now priced for Sep. ▪ The CTI Global Rates base case view is no cuts in 2023, with a best case of potentially one cut. Expect rates to peak between 5-5.25% in first half, with Fed holding 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, strong China reopening, Europe sees commodity pressure easing, consumer retains strength, end of Russian Invasion of Ukraine ▪ Downside risks: simultaneous low unemployment, high inflation, hiking, and slowing growth cause a recession. Russian invasion spills into broader global/China turmoil. New Covid variant. Supply chain disruptions, inflation, volatility, commodity shocks persist 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 ▪ Hiking cycles to be curtailed by the impact of tighter credit conditions post SVB	▪ 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 unch since mid-March. Technicals weaker ▪ Moving into select relval opportunities while maintaining conservative positioning ▪ Tailwinds: China reopening optimism , central bank easing in countries with receding inflation. ▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, increasing use of IMF programs, geopolitical risks	▪ China/US relations deteriorate ▪ Issuance slows ▪ Chinese reopening paused ▪ Continued spill over from Russian invasion: local inflation (esp. food & commodity), slowing growth in trade partners, supply chains ▪ Persisting COVID growth scars hurt economies & fiscal deficits
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ US & EMEA spreads have widened in the past month; fundamentals and technicals still weak to pre-covid. EUR valuations are cheap, GBP vals fair to USD. ▪ Earnings season confirmed the theme of resilient corporate balance sheets, with low leverage and stable margins. The fundamental concerns remain focused on elevated macro risks from the US banking crisis, commercial real estate, tight labor supply, weaker consumer, and elevated recession concerns	▪ Additional bank failures with too little governmental intervention ▪ Volatility remains high and 2023 suppluis 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 have widened since mid-April, fundamentals and technicals remain unchanged. Prefer conservative position while open to attractive buying opportunities, especially in short HY.US HY default forecast increased, driven by global banking stress, recession fears, margin pressure, demand deterioration and idiosyncratic sector risk ▪ 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 has continued to widen. Since Feb, the group has reduced exposure due to outperformance. Mortgage index has continued to widen. Since Feb, the group has reduced exposure due to outperformance. ▪ Supply picking up due to seasonals, still below expectations. FDIC liquidations from SVB/Signature beginning with lists trading better than expectations ▪ 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: Investors cautious, especially on office. Credit curve is very steep; non-office sectors remain stable. ▪ CLOs: Spreads unch since April. 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
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper ▪ o/w Grains ▪ u/w Gold ▪ o/w Oil ▪ u/w Silver ▪ u/w Wheat ▪ o/w Corn	▪ Global Recession