COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

12 September 2022

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'The hawk with talent hides its talons'.

Japanese proverb.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.30%	11 bps	-2.1%	-11.1%
German Bund 10 year	1.68%	15 bps	-2.0%	-13.0%
UK Gilt 10 year	3.09%	17 bps	-8.9%	-22.3%
Japan 10 year	0.25%	1 bps	1.4%	-3.2%
Global Investment Grade	159 bps	-4 bps	-0.8%	-13.7%
Euro Investment Grade	192 bps	-8 bps	-0.1%	-12.3%
US Investment Grade	147 bps	-3 bps	-0.9%	-14.7%
UK Investment Grade	164 bps	-2 bps	-5.2%	-16.9%
Asia Investment Grade	224 bps	2 bps	-0.8%	-9.0%
Euro High Yield	555 bps	-32 bps	3.8%	-11.9%
US High Yield	457 bps	-49 bps	4.7%	-10.0%
Asia High Yield	939 bps	-8 bps	0.0%	-19.2%
EM Sovereign	413 bps	-18 bps	2.0%	-17.2%
EM Local	6.9%	2 bps	0.4%	-14.2%
EM Corporate	377 bps	-8 bps	0.9%	-13.2%
Bloomberg Barclays US Munis	3.4%	6 bps	-0.5%	-9.4%
Taxable Munis	4.7%	11 bps	-2.5%	-18.2%
Bloomberg Barclays US MBS	48 bps	7 bps	-1.4%	-10.1%
Bloomberg Commodity Index	257.47	-0.4%	1.7%	20.5%
EUR	1.0140	0.9%	-4.2%	-11.7%
JPY	142.76	-1.6%	-4.7%	-19.2%
GBP	1.1674	0.7%	-4.8%	-14.4%

Source: Bloomberg, Merrill Lynch, as at 9 September 2022.

Table of the week: Euro interest rate expectations – Next 3 years

Today's rate	0.75%
3-months	2.37%
6 months	3.01%
12 months	3.10%
24 months	2.86%
36 months	2.78%

Source: Bloomberg Columbia Threadneedle Investments, as at 12 September 2022.

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Macro / government bonds

The sell-off continues. Government bond yields continue to rise as 2022 looks set to be the worse year for total returns in decades. The week was also characterised by central bankers seemingly competing to be seen as the most hawkish about the direction of interest rates. This rhetoric is some distance from what was being said or forecast only a year ago.

It was also a week punctuated by a 'full on' 75bps tightening in European interest rates, the largest single move in the European Central Bank's history. The ECB is playing catch-up with fellow central banks and (as mentioned) with its own previously dovish outlook. We can expect more hikes to come **(see 'Table of the week')**, perhaps even another 75bps move in November. The ECB also upgraded inflation forecasts especially in the near term. Furthermore, it has also suspended a 'two tier' system (which was really needed when rates were negative) and stated that bank deposits as well as government deposits would be remunerated at the deposit rate (75bps). This reduces the attractiveness of German paper for government institutions, which added to the sell-off at front end of the German yield curve, and tightened swap and peripheral government bonds spreads.

The US looks set for another 0.75% hike later this month as Chair Powell continued to underline the US Federal Reserve's commitment to tackle inflation in a speech last week. The US has seen a fairly material tightening in monetary conditions this year. Firstly, interest rates themselves have risen four times so far and by 225bps. Mortgage rates have followed suit with 30-year Freddie Mac borrowing costs at around 5.9%; these are the highest housing borrowing costs since the Global Financial Crisis. For companies, corporate borrowing costs have also skyrocketed as government bond yields have risen and spreads have widened. Meanwhile, with the US dollar at parity to the euro, the squeeze on exporters continues. However, if the Fed is looking for signs that tighter policy conditions is slowing the economy and leading to layoffs the weekly jobless claims data has not played ball. Weekly claims have actually been on a declining trend these past few weeks.

As we mentioned last week, in terms of underperformance, the UK takes some beating. Gilt yields have risen by 2% this year, interest rates are expected to 'top-out' at over 4% next year (from 1.75% today) and sterling has collapsed with several forecasters talking about parity to the US dollar this year as a target. To assist the beleaguered UK consumer, newly appointed Prime Minister Truss delivered on her promise to help pay energy bills, with a £2,500 cap for the next 24 months.

Investment grade credit

Credit spreads were a little better / tighter last week. After widening from mid-August, spreads have found support, albeit against a background of heavy new issuance, poor liquidity conditions and outflows from the market.

At the margin, and after considerable underperformance, it was the euro market that performed best, aided no doubt by a sharp tightening in swap spreads (see comment above in the Macro / government bonds section). We continue to view euro IG spreads as the most attractive globally. Interestingly, while US dollar spreads are close to their long-term average, their euro denominated cousins spreads have widened by double the amount (in percent terms) and are around one standard deviation cheap historically.

High yield credit & leveraged loans

High yield bond spreads retraced the prior week's widening amid widely anticipated hawkish Fed rhetoric and a slow start for the supply calendar. The ICE BofA US HY CP Constrained Index returned 1.37% and spreads were 49bps tighter over the week. According to Lipper, high yield retail funds reported a $2.2bn outflow with nearly $12bn withdrawn over the previous three weeks. The supply calendar is expected to increase in upcoming weeks after producing only $1.5bn of issuance thus far in September. Meanwhile, the steady decline in leveraged loan prices since mid-August subsided this week amid positive economic data and hawkish central bank language. The average price of the J.P. Morgan Leveraged Loan Index declined $0.06 to $94.34. Loan retail fund flows totalled -$770m over the week.

It was a firm week for European High Yield (EHY) as the index spread tightened in 32bps to 555bps and yields fell 0.11% to 7.36%. EHY returned 0.49% with CCCs outperforming higher rated credits. Outflows slowed down and were mainly from managed accounts as ETFs experienced buying demand with prices moving to a premium of ½ point by the end of the week. It was overall a constructive market with stronger buying coming through. Although this was largely led by ETFs, some real money buying started to come through by Friday. Corporate primary market was still closed but talk has picked up regarding new issuance given the backlog of potential deals (some waiting since the end of 2021).

In credit rating moves, Moody's downgraded AMS-Osram, light technology firm, from Ba3 to B1 citing "slower than expected achievement in margin improvement and related high leverage for a prolonged period following the acquisition of Osram." S&P and Fitch are still maintaining their BB- rating, for now.

In M&A news, Paprec, the recycling and waste management company, announced the acquisition of the French metal recycler Menut, which has 16 sites in the country.

On inflation and rising costs, Lufthansa released some details on the pay increases with talk that pilots will get a €980 increase in two stages. Other aspects are still being negotiated but with an agreement that there will not be any further actions until June 2023.

Structured credit

It was a tough week for the mortgage sector with returns down 1.07%. Duration-sensitive assets struggled generally as rates bear steepened on ISM services numbers. The overall trend for spreads has been wider in sympathy with risk assets. That trend saw some reversal last week alongside IG and HY corporates. Gross and net supply in Agency MBS continues to drop on lower purchase activity and cash-out refis. Bank demand has also cooled as deposit growth slows. In Non-Agency, performance continues to be strong, however, mortgage rates in the +6% camp creates some headwinds for fundamentals. CMBS spreads have been relatively flat. In ABS, market appetite has been surprisingly strong, allowing for good execution levels to exit positions where fundamental performance is showing early signs of deterioration (ie, unsecured consumer consolidation loans).

Asian credit

The Indonesian government has raised the price of subsidised fuel (Pertalite gasoline, diesel) by more than 30% to reduce the country's subsidy burden. The price of the non-subsidised Pertamax gasoline was also raised by 16%. The fuel price hike is generally positive for the fundamental operations of Pertamina given the scope for lower receivables and better cash flow generation. However, the higher inflationary pressure and the risk of lower economic growth could weigh on Pertamina given its strong linkage with the sovereign.

The tower company, edotco Group, which is 63% owned by Axiata Group is reportedly looking to raise as much as $600m through share sales. The share sales would be positive for edotco, which together with Edge Point Infrastructure in April 2022, announced the joint acquisition of tower assets from PLDT (Philippines) for $1.4bn. Axiata Group's leverage, with a net debt/EBITDA of 2.5x at June 2022 (Q4, 2021: 2x) has risen due to M&A. Management expects the merger between Axiata Group's wholly owned Celcom (mobile telecom business in Malaysia) with Digi (49%-owned by Telenor) to be completed in H2, 2022.

In the Chinese property sector, several property developers have faced winding-up petitions: Sunac Evergrande, Yango Justice, Fantasia and Sinic. These winding-up petitions are likely targeted to force the property developers to speed up and improve their restructuring proposals for offshore creditors. The latest winding-up petition was made against Sunac by a bondholder (Chen Huaijun), and the court hearing will be held in November 2022. Typically, the court hearing process is protracted as seen with the petition made against Evergrande. During the first hearing on the winding-up petition against Evergrande, the Hong Kong judge said that an immediate liquidation (as requested by the petitioner) would disrupt Evergrande's ongoing efforts to work out a restructuring proposal for all offshore creditors. The next hearing has been adjourned to late November 2022 and Evergrande is reportedly aiming to present a more detailed restructuring plan by then.

Emerging markets

The EMBI index rallied 0.5% on the week led by gains in Ecuador and Ghana, with distressed names such as Pakistan, Zambia and Lebanon weighing on returns.

In Colombia, the government will begin to reduce fuel subsidiaries to reduce the strain on the nation's fiscal deficit. The subsidies on gasoline and diesel would have costed approximately 2.5% of GDP this year. The government will also look to enforce more controls on the taxation of fuel companies.

In Egypt, inflation rose to 14.6% y/y in August with food rising 23.1% m/m. Inflation may be close to peaking following the rapid rises in food and energy costs alongside the devaluation of the Egyptian pound. Elsewhere, August CPI printed at 2.5% for China, 8.7% for Mexico and 80.2% for Turkey.

In central bank news we had rates hikes from Poland (+25bps), Chile (+100bps), Malaysia (+50bps), Serbia (+50bps) and Peru (+25bps).

Commodities

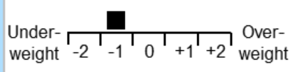
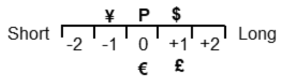
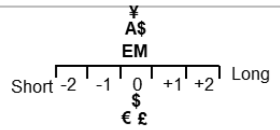
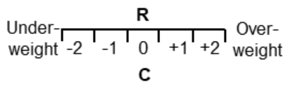
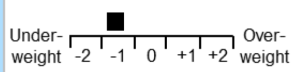
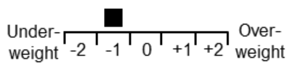
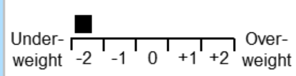
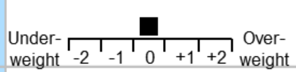
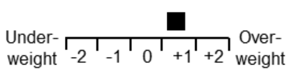
The BCOM index delivered a slight negative return driven by losses in US natural gas. Prices declined 9.1% on the week as a result of milder weather in the US Northeast, while the rest of the energy complex was flat on the week.

Industrial metals delivered a positive return as nickel rallied 12%, prices were supported by supply concerns alongside the weaker US dollar following the ECB's 75bps rate hike. Elsewhere, copper prices rallied 4% following the news of China's copper imports rising 26% y/y in August. China has been ramping up technology and green based infrastructure projects and are the top consumer and importer of copper.

Summary of fixed income asset allocation views (as at 12 September 2022)

Fixed Income Asset Allocation Views
12th September 2022

COLUMBIA THREADNEEDLE INVESTMENTS

Strategy and positioning (relative to risk free rate)		Views	Risks to our views
Overall Fixed Income Spread Risk		▪ Credit spreads have tightened since the last meeting with volatility still high and a market-wide softening in technicals and fundamentals. This has **kept the group negative on credit risk.** ▪ We are past the peak of economic growth with first few hikes done and expectations for more 50-100bp hikes through the end of 2022. Pullback in liquidity created opportunity for market volatility. ▪ Uncertainty remains elevated due to fears surrounding pace of central bank hiking, inflation, recession probabilities, weakening consumer profile and the Russian invasion of Ukraine.	▪ Upside risks: the Fed achieves a soft landing, Europe sees commodity pressure easing, consumer retains strength ▪ Downside risks: simultaneous low unemployment, high inflation, hiking, and slowing growth cause a recession. Russian invasion spills into broader global/ China turmoil. New Covid variants. Supply chain disruptions, inflation, commodity shocks persists to Q4 2022.
Duration (10-year) ('P' = Periphery)		▪ Carry offered by front end yields now attractive in UK ▪ 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 may be curtailed by weakening growth, as risk of a policy error increases	▪ 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)		▪ The invasion of Ukraine will hit global growth, hinder risk markets and lend a bid to the Dollar ▪ The repricing of the ECB has so far failed to boost the Euro as Eurozone growth expectations have underperformed the US	▪ End of zero-covid strategy in China normalises supply chains and raises global growth, to the detriment of the Dollar
Emerging Markets Local (rates (R) and currency (C))		▪ Substantial monetary policy tightening now embedded into EM local rates ▪ Aggressive Fed pricing may now open the door to selective EMFX performance ▪ EM real interest rates relatively attractive, curves steep in places	▪ Negative sentiment shock to EM fund flows ▪ Central banks tighten aggressively to counter fx weakness ▪ EM inflation resurgence ▪ EM funding crises drive curves higher and steeper ▪ Tightening global financing conditions
Emerging Markets Sovereign Credit (USD denominated)		▪ Strong month for EMD returns with tightening spreads and rallying in oversold names; still seeing bifurcation in market ▪ Fundamental headwinds: elevated fiscal deficits, rising debt to GDP ratios, significant inflation, Chinese lockdown/growth, idiosyncratic political risks, increasing use of IMF programs ▪ Recent commodity price retracement has refocused attention on underlying fiscal health; benefiting commodity importers and harming exporters; fundamental ▪ Techincals (outflows and supply) remain a headwind	▪ Chinese growth derails with less stimulus and uncertain zero covid policy after economy reopens ▪ Continued spillover 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		▪ US & EMEA spreads have tightened after hitting YTD wides in July, supported by positive economic data. ▪ Stable fundamentals beat pessimistic expectations for Q2 earnings. Inflation, labor supply and monetary tightening, however, remain headwinds pressuring margins and operating environment in Q3 2022. ▪ Technicals have improved with reopening new issue market, positive fund flows and better liquidity	▪ Remaining Q2 earnings show surprise weakness, materially lower Q3 outlooks ▪ Market indigestion as central banks sell EMEA corporates ▪ Rate environment remains volatile ▪ Russian invasion worsens operating environment globally
High Yield Bonds and Bank Loans		▪ Spreads have quickly tightened after hitting YTD wides in May/June. Combined with greater downside risks, the group prefers conservative positioning while remaining open to attractive buying opportunities ▪ Technicals remains a headwinds with light primary issuance, however fund flows are shifting positive and default activity remains benign/idiosyncratic ▪ Bank loan market has moved higher with more new issues and non-traditional loan investors; concerns about recession and interest cost remain headwinds	▪ Default concerns are focused on demand destruction, margin pressure and macro risks ▪ Loan technicals & flows weaken ▪ Russian invasion & spillover rattles US bond loan/market as already seen in EMEA ▪ Commodity prices continue to retrace
Agency MBS		▪ Mortgages recently outperformed as volatility dropped and spreads tightened. ▪ Prefer higher coupon because of more attractive valuations, carry, priority in Fed sales and sponsorship ▪ Mortgage spreads have stabilized in past month at historically wide levels, supply continues to drop along with purchase activity and cash out refinancing	▪ Housing activity slows and rising rates move prepays to normal levels without hurting mortgage servicing rates. ▪ Uncertainty with the Fed hiking and future balance sheet position ▪ Less bank holdings of MBS as deposit growth slows
Structured Credit Non-Agency MBS & CMBS		▪ Our preference remains for Non-Agency RMBS ▪ RMBS: Spread slightly better with stable fundamental performance , but expect normalization coming from heavy supply, extension concerns and general risk off. Prefer to move up in quality and seasoning ▪ CMBS: Mostly solid fundamentals but weakening. Spreads flat MoM. Better relval in other sectors, continue to trim. ▪ CLOs: Spreads tighter MoM but lagging competing products. AAA spreads over 200 are attractive from long-term perspective. ▪ ABS: US consumers are stable but with areas of weakness-trimming exposure to inflation-sensitive borrowers	▪ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening, consumer retail/travel behavior fails to return to pre-covid levels ▪ Work From Home continues full steam-ahead post-pandemic (positive for RMBS, negative for CMBS). ▪ SOFR deals slows CLO new issue ▪ Rising interest rates dent housing market strength
Commodities		▪ o/w Copper & Lead vs Zinc ▪ o/w Softs ▪ o/w Grains ▪ u/w Gold ▪ o/w Oil ▪ u/w Silver	▪ Global Recession