COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

13 February 2023

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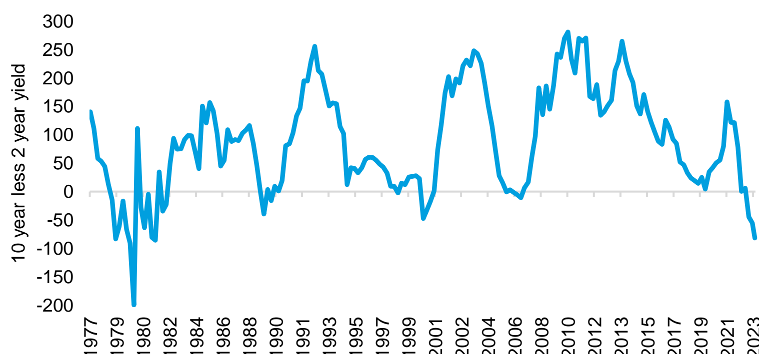
Curve inversion continues.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index YTD return	1 Year return
US Treasury 10 year	3.72%	20 bps	1.1%	-8.6%
German Bund 10 year	2.37%	18 bps	1.1%	-14.0%
UK Gilt 10 year	3.40%	35 bps	1.9%	-18.7%
Japan 10 year	0.51%	2 bps	1.4%	-4.0%
Global Investment Grade	129 bps	1 bps	2.3%	-8.7%
Euro Investment Grade	141 bps	-1 bps	2.1%	-9.2%
US Investment Grade	123 bps	3 bps	2.3%	-9.0%
UK Investment Grade	137 bps	-1 bps	3.4%	-10.6%
Asia Investment Grade	194 bps	0 bps	2.2%	-5.5%
Euro High Yield	432 bps	-12 bps	4.3%	-5.1%
US High Yield	424 bps	29 bps	3.1%	-5.2%
Asia High Yield	597 bps	16 bps	6.9%	-3.9%
EM Sovereign	369 bps	16 bps	1.8%	-11.6%
EM Local	6.6%	11 bps	2.7%	-11.1%
EM Corporate	321 bps	1 bps	2.5%	-8.0%
Bloomberg Barclays US Munis	3.2%	12 bps	2.4%	-3.6%
Taxable Munis	4.9%	19 bps	4.3%	-12.4%
Bloomberg Barclays US MBS	42 bps	4 bps	1.9%	-7.2%
Bloomberg Commodity Index	237.86	1.6%	-3.1%	1.8%
EUR	1.0717	-1.1%	-0.3%	-6.6%
JPY	132.69	-0.1%	-0.2%	-11.7%
GBP	1.2131	0.0%	-0.2%	-11.0%

Source: Bloomberg, Merrill Lynch, as at 10 February 2023.

Chart of the week: US yield curve (10y less 2y), 1977-2023



Source: Bloomberg, Columbia Threadneedle Investments, as at 10 February 2023.

5462571 Issued February 2023 | Valid to end April 2023

Macro / government bonds

Bonds got off to an extraordinarily strong start in 2023 but more recently returns have been negative. All the while, the US government yield curve has continued to invert in a trend in place since spring of 2021. The 10-year less 2-year curve is around the most inverted in 40 years **(see chart of the week)**. In the past, such inversion has been a harbinger of upcoming recession. It is also a reflection of rising rate expectations (2-year) and falling inflation (longer end of the curve).

The benchmark US 10-year bond yield, which reached 4.25% in October 2022 fell to around 3.4% last month. Since then, around 30bps of yield has been added in a more challenging time for government bonds. The presumption that US interest rates would 'terminate' at under 5% has been dented by ongoing strength in the labour market and a fear that heightened levels of inflation will pass through to rising wage growth – meaning more for central banks to do in the coming months. As we ended last week, US rate expectations had risen to around 5 1/8% by Q3 of this year. US Federal Reserve officials have been keen to retain or underline the view that rates will need to go above 5% at upcoming meetings.

In other news, we received weaker GDP growth data than expected from the UK – but no technical recession. Q4, 2022 growth was flat after the 0.3% contraction in the third quarter. Weakness in Q4 was found more in the important service sector than in other areas of the economy. Meanwhile, in Germany the delayed consumer price inflation report showed a decline in inflation to 9.2% in January from 9.6% the prior month on the HICP measure. News that European gas prices have now tumbled to a 17-month low will also be welcomed in terms of lower inflation but also in terms of spending power for consumers.

Investment grade credit

Investment grade markets have also enjoyed a strong start to the year. Lower yields (discussed above) and tighter spreads have combined to help deliver impressive investment grade market returns. In the last week or so government bond yields have risen and spreads have stalled.

Technically, though new issuance has been robust and well received, data from investment bank JP Morgan showed the first outflows from euro and sterling IG strategies this year. We might assume that lower yields and spreads, which are now closer to long run averages, have reduced investor interest after the strong returns seen since mid Q3, 2022.

High yield credit & leveraged loans

European High Yield (EHY) paused its YTD market rally as it gave back some performance last week (-0.2%). This was largely due to the rise in underlying government yields as spreads continued to tighten (-12bps to 432bps) and credit compression stayed on course with CCCs outperforming higher rated credits. Sterling high yield also outperformed EHY for another week. Flows into the asset class remain steady, benefiting both ETFs and managed accounts and reaching €1.1bn YTD. Post the slow start last week, the primary market really picked up with €2.2bn via four (eg, Iliad, Ineos) offerings on the corporate side (largely BB rated), including €1bn from Ford. All were well received with pricing coming inside of initial price talk. Interestingly, post issuance pricing was not always as robust as seen in January.

In credit rating news, Nokia was upgraded by S&P to BBB- and to BA1 by Moody's. This means Nokia will exit high yield indices at the end of February (Ba1/BBB-/BBB-). Not great news for TALKTALK though as S&P downgraded it to B-. The last one to note was that Moody's downgraded HSE (German on-line shopping) to B3.

Looking at market valuations, EHY is no longer looking cheap relative to US high yield. This is especially the case in the higher rated credits (BB= through B+) as there is still a pick-up (50 to 75bps) for the lower rated (B through CCC+). On a sector basis, gaming continues to look resilient while specialty chemicals are still reporting weakness with a decline in sales and fall in EBITDA (eg, Chemours) but also now suggesting a rebound in 2H, 2023.

Structured credit

The US Agency MBS market struggled last week against improved economic news which pushed rates higher. Performance across 15s and 30s was similar while higher coupons (lower durations) outperformed. Spreads on current coupon 15s and 30s both widened 18-20bps.

Demand continues to weigh on money managers with the Fed focused on balance sheet winddown. The headline prepay speeds in January continued to slow, down 18% for 30-year conventionals, non-agency RMBS spreads tightened 20-50bps last week, with steady new issuance well bid and oversubscribed multiple times. In CMBS, delinquencies remained in-check but underlying fundamentals are slowing particularly in the office segment. Spreads have tightened materially but remain wide to historical averages. In ABS, lower quality borrowers are struggling in subprime auto and consumer loans. Nine deals, totalling $6.7bn, priced last week with another six currently marketing to price this week.

Asian credit

The Adani promoters has pledged additional shares for a SBI loan ($300m) associated with the Carmichael coal mining project in Australia. The additional pledges of shares in Adani Ports, Adani Transmission and Adani Green Energy are due to the ongoing pressure on the equity valuations. That said, on 6 February 2023, the promoters had prepaid loans ($1.1bn), which already released a substantial number of pledges shares of the operating subsidiaries.

The Financial Services Commission (FSC) of Mauritius stated that, based on its preliminary investigation, the 38 global companies and 11 funds associated with Adani Group are compliant with Mauritius regulations. The FSC of Mauritius is cooperating with the Securities and Exchange Board of India (SEBI).

The Adani Group has also reduced its revenue growth target by half and it plans to suspend new capital expenditure. Specifically, instead of targeting 40% of revenue growth, it is now planning for a revenue growth of 15% to 20% at least over the next financial year.

Fitch views that that Indian banks face limited risk from the Adani Group issues given that the banks' exposures are relatively small. Fitch believes that the loans to all Adani group entities account for around 0.8% -1.2% of the total lending for Fitch-rated India banks.

Emerging markets

A combination of wider spreads (+16) and higher US treasury yields resulted in a negative return for EM hard currency sovereigns over the last week (-2.30%). The high yield sub-sector fared the worst as high beta names in Africa and Latin America struggled. Investment grade bonds had a negative week too as they followed US treasuries.

A huge earthquake and subsequent aftershocks caused devastation in Turkey and Syria last week with the death toll surpassing 35,000. Turkish construction companies have faced criticism with over 100 arrest warrants already being issued. President Erdogan has also come under pressure due to the inadequate disaster response.

In China, loan growth beat expectations rising by 23% YoY following the front loading of credit extensions by the government. The rise was driven by loans to the corporate sector with household loans (principally mortgages) lagging, driven by jobs market uncertainty. Furthermore, the M2 measure of money supply rose 12.6% YoY, the fastest increase since 2016. In further positive news, data from the National Bureau of Statistics showed both China's manufacturing and services PMIs were in expansionary territory.

In Poland, policy makers continued to hold rates at 6.75% but said discussions on rates cuts were premature. In Mexico, interest rates were hiked 50bps to 11% as inflation continues to accelerate.

In ratings news, Egypt was downgraded one notch by Moody's to B3 owing to dwindling FX reserves.

Commodities

The BCOM index rallied 1.6%. Energy markets performed strongly (+6.7%) with industrial metals selling off the most (-3.4%).

Agricultural markets were also a bright spot with Chicago wheat contracts rallying 3.7% as the Russia/Ukraine conflict intensified, with Russia firing over 100 missiles at Ukrainian energy infrastructure. There's concern infrastructure damage could restrict Ukrainian exports in addition to the risk that the previously agreed Black Sea export deal with Russia could be suspended when it comes up for renewal in March.

Brent performed strongly (+7.9%) supported by the return of Chinese demand and Russia announcing supply cuts of 500,000 barrels a day. The EU claims Russia was forced to make these cuts because of sanctions resulting in Russia struggling to find buyers despite accepting significant price discounts. Looking forward, OPEC expects to see a lack of investment will increase production supporting prices; elsewhere a Reuters survey expects brent to average $89 in 2023.

Responsible Investments

After one of the busiest months of issuance we have encountered for a while, ESG bond issuance had its fair slice of the bond issuance pie in January. According to data from Bloomberg, we had almost three times as much Green, Social, Sustainable and Sustainbility-Linked bond issuance in January 2023 vs December 2022. Although shy of the €106bn we saw last January, the €93.4bn we did see shows us a good sign of what's to come if this trend continues. As mentioned a few weeks ago, we should see another near record year of issuance at the end of 2023.

The UK Government's Environment Secretary has reportedly pulled back from upping fines issued to water companies who pollute rivers, streams and seas with overflowing sewage. The previous Environment Secretary had put plans together to increase fines from £250,000 to £250m, a rise that has now been pushed aside.

In a first for Australia, plans of a major coal mine near the Great Barrier Reef have been rejected by an Australian Minister. It's the first time the Environment Protection and Biodiversity Conservation Act has been used as the minster stated the risks to the enviroment were "simply too great".

Lastly, for those readers thinking of buying their first or next electric vehicle, Rolls Royce has released its first ever one! The Spectre can be bought for a cool $500,000 and looks to be delivered as early as the end of this year. Although, if you are thinking of driving it around the country lanes of the UK, I would think twice as it's nearly 18ft long and over 6ft wide. You might not fit on the road but you will certainly have presence.

Fixed Income Asset Allocation Views

13th February 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 (■ at -1)	▪ Valuations are less attractive relative to December, technicals and fundamentals stable to improving. **The group remained negative on credit risk, upgrading Investment Grade to neutral and downgrading Structured Products to neutral.** ▪ The Fed Funds market is pricing in a peak of 5% and rates being cut to 4.5% in 2023 ▪ The CTI global Rates base case view is no cuts in 2023, with a best case of potentially one cut. They expect rates to peak between 5 – 5.25% in first half, with Fed holding steady through the second half. ▪ Uncertainty remains elevated due to fears surrounding recession probabilities, schedule of central bank hiking/easing, persisting inflation, weakening consumer profile and the Russian invasion of Ukraine.	▪ Upside risks: the Fed achieves a soft landing, 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 to 2023.
Duration (10-year) ('P' = Periphery)	Short -2 -1 0 +1 +2 Long (¥ at -1, P at 0, $ at +1; € at 0, £ at +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 ▪ Hiking cycles may be curtailed by weakening growth, as risk of a policy error increases ▪ change in UK fiscal position to contractionary is a positive for the front end	▪ 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 (¥, A$, EM at 0 above; $, €£ at 0 below)	▪ Rising expectations around a soft landing and peak Central Bank rates have weakened the dollar ▪ China reopening has amplified this by boosting growth expectations helping risk markets ▪ A material weakening of the dollar from here will need to see growth expectations move significantly higher	▪ 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 at +1; C at 0)	▪ Substantial monetary policy tightening now embedded into EM local rates; inflation peaking in some places ▪ 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 peaks higher and later ▪ EM funding crises drive curves higher and steeper ▪ Further rises in DM yields
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight (■ at 0)	▪ EMD spreads unchanged since last meeting, following strong Q4 spread compression and performance. ▪ China reopening story is huge turnaround since November. ▪ Fundamental headwinds: elevated fiscal deficits, rising debt to GDP ratios, significant inflation, central bank tightening, idiosyncratic political risks, difficult global financing conditions (US rates and USD strength), increasing use of IMF programs, geopolitical risks ▪ Technicals improving with higher new year issuance	▪ Chinese reopening paused – weakened property market and confidence drag on growth ▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight (■ at 0)	▪ US & EMEA spreads have continued tightening to less attractive valuations as fundamentals remain stable and technicals remain soft. ▪ Fundamentals remain stable, with strong starting point – expected deterioration may be a 2023 story. ▪ Inflation, labor supply, low dispersion and monetary tightening continue to pressure margins and operating environment. All eyes on Q4 results and '23 outlooks.	▪ Supply remains low. ▪ M&A expected to slow; cash flow prioritizing shareholder payouts ▪ Market indigestion as central banks sell EMEA corporates ▪ Rate environment remains volatile ▪ Russian invasion worsens operating environment globally
High Yield Bonds and Bank Loans	Under-weight -2 -1 0 +1 +2 Over-weight (■ at -1)	▪ Spreads have moved tighter. Prefer conservative position while open to attractive buying opportunities. ▪ Technicals have started to improve with positive fund flows and no defaults in December; more rising stars than fallen angels in 2022. Fundamentals still stable. ▪ Expect 2023 performance will be driven by credit selection amidst fundamental dispersion and distress. ▪ Bank loan market has tightened: market is in equilibrium with fund outflows offset by stable CLO formation and lower new supply.. Concerns about recession and interest cost remain headwinds.	▪ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks ▪ Loan technicals & flows weaken ▪ Global consumer health weakens ▪ Russian invasion & spillover ▪ Commodity prices retrace
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight (■ at +1)	▪ Mortgage index has tightened along with other risk assets. Despite outperformance, valuations still attractive from historic perspective and volatility remain elevated. ▪ Headwinds as money manager demand is small relative to Fed, bank, REIT and overseas selling pressure ▪ Place to add as preference shifts to high quality assets and sentiment is constructive over longer time horizon	▪ 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 in recessionary scenario
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight (■ at 0)	▪ Our preference remains for Non-Agency RMBS ▪ RMBS: Higher mortgage rate is headwind for prepays, fundamentals and transaction activity. Delinquency performance remains strong, but housing is slowing. Risk premiums still cheap to historical averages but tightening. ▪ CMBS: Mostly solid fundamentals but weakening. Spreads attractive for historical CMBS, but better relval elsewhere. ▪ CLOs: Spreads tighter since December. Default rate increasing and slow new issue supply to start the year ▪ ABS: Lower income, renters, lower fico borrowers continue to underperform, higher quality borrowers remain stable.	▪ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening, Consumer retail/travel behavior 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 (■ at +1)	▪ o/w Copper ▪ o/w Grains ▪ u/w Gold ▪ o/w Oil ▪ u/w Silver	▪ Global Recession

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