COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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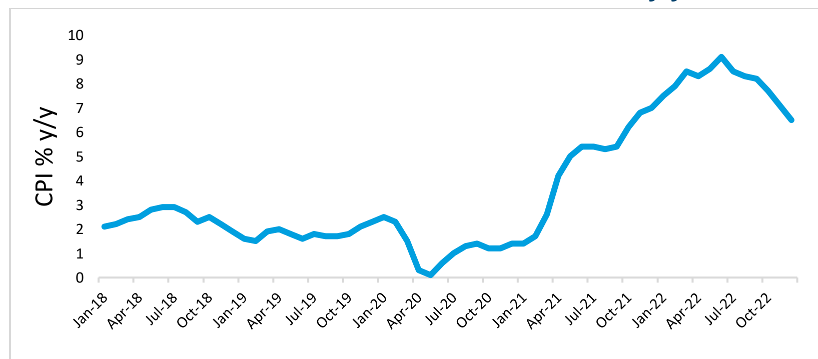
A farewell to inflation.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index YTD return	Index 1 year return
US Treasury 10 year	3.50%	-5 bps	2.4%	-9.6%
German Bund 10 year	2.17%	-4 bps	2.4%	-15.2%
UK Gilt 10 year	3.39%	-8 bps	2.7%	-22.0%
Japan 10 year	0.53%	2 bps	1.4%	-5.8%
Global Investment Grade	141 bps	-8 bps	2.8%	-11.2%
Euro Investment Grade	159 bps	-8 bps	2.0%	-12.0%
US Investment Grade	132 bps	-8 bps	3.2%	-11.3%
UK Investment Grade	147 bps	-13 bps	3.0%	-14.7%
Asia Investment Grade	210 bps	0 bps	2.3%	-6.5%
Euro High Yield	475 bps	-34 bps	2.6%	-9.4%
US High Yield	421 bps	-26 bps	3.9%	-7.2%
Asia High Yield	661 bps	-3 bps	5.3%	-4.2%
EM Sovereign	379 bps	-13 bps	2.5%	-12.5%
EM Local	6.6%	-14 bps	4.4%	-8.1%
EM Corporate	348 bps	-7 bps	2.0%	-9.7%
Bloomberg Barclays US Munis	3.2%	-18 bps	2.3%	-5.5%
Taxable Munis	4.8%	-11 bps	4.9%	-15.5%
Bloomberg Barclays US MBS	39 bps	-5 bps	3.0%	-8.1%
Bloomberg Commodity Index	243.64	3.3%	-0.9%	10.7%
EUR	1.0818	1.7%	1.2%	-5.5%
JPY	128.35	3.3%	2.5%	-10.7%
GBP	1.2202	1.1%	1.2%	-10.8%

Source: Bloomberg, Merrill Lynch, as at 13 January 2023.

Chart of the week: US Consumer Price Inflation % y/y



Source: Bloomberg, Columbia Threadneedle Investments, as at 16 January 2023.

Macro / government bonds

Government bond markets have rallied strongly this year. The benchmark US 10-year bond kicked off 2023 with a yield of around 3.9% and is closer today to 3.5%. Meanwhile, lower inflation has helped prompt speculation that we are close to the peak or terminal rate of interest in this present cycle, which has been expected to be around 5% by mid-2023.

Last week's big news was the key US Consumer Price Inflation print. It came in exactly as expected. Headline inflation declined by 0.1% in the month and is now 6.5% y/y higher than a year ago **(see chart of the week).** The decline was led by lower energy prices as oil is trading at a lower price than before Russia invaded Ukraine. The Core (ex food and energy) inflation number showed a 5.7% y/y expansion, and inflation has now declined from a high print of 9% in the middle of last year. Markets responded surprisingly well to this data release and seem happier that the declining trend is intact even though the actual data release was no better than consensus expectations.

After today's Martin Luther King holiday, we get Retail Sales and Producer Price Inflation data from the US. In the UK we will receive employment and inflation data and the Bank of England's Bailey will give a talk today. Over in Europe, Christine Lagarde is attending and speaking at the Davos summit on Thursday and Friday.

Investment grade credit

Investment grade credit markets continue to rally with global spreads a shade above the 140bps level. Spreads were around 185bps in October last year so this is a decent move tighter in the last three months. The rally has been led by UK and euro denominated markets, which had lagged meaningfully last year. Global spreads now sit fairly and squarely on the long run average (20-year).

Friday brought US bank results. Overall, results were in line with no surprises. Margins continue to expand, while the cost of risk is normalising. Markets businesses were fairly strong and capital expanded modestly.

Primary markets set new issuance records last week so a heavy burden of new issuance to digest and mostly from financials. It appears this supply has been well received as evidenced by tighter spreads.

High yield credit & leveraged loans

US high yield continued its strong start to the year, aided by a light new issue calendar, lower interest rates and retail fund inflows. The ICE BofA US HY CP Constrained Index returned 1.57% and spreads were 25bps tighter.

According to Lipper, the asset class saw a $2.5bn inflow, which was the largest weekly inflow since mid-November. Despite ongoing outflows, leveraged loans also continued to perform well over the second week of the year, albeit lagging high yield bonds, with the average price of the J.P Leveraged Loan Index increasing $0.53 to $93.90. Loans experienced their 21st consecutive weekly outflow with $279m withdrawn over the week.

European High Yield (EHY) had another strong week for the first month of 2023 as spreads tightened an additional 34bps resulting in a return of 1.5% for the week with some performance also coming from falling government yields. It was a strong risk on week with CCCs outperforming BB and B and sterling high yield outperforming EHY. Fund flows continued to be positive, though mainly into ETFs (which were trading at a premium for much of last week). In the primary market, new issues are expected over the coming weeks but will likely be focused on refinancing's or exchanges rather than new money coming into the asset class.

In sector news, strong positive trading figures for the airline sector (eg, Ryanair and Wizzair are reporting above 2019 sales levels while Ryanair upped its FY 22 outlook by 25%) and UK retail sector (with the exception of Matalan who is going through restructuring). Positive news for UK retail (eg, M&S and Iceland) has been supported by the normalisation of energy prices. Cruise lines (Carnival, Norwegian Cruise Line, Royal Caribbean Cruise) are also reporting strong books since the start of the year.

In issuer specific news, it was reported that Lottomatica, the Italian gaming company, is likely to IPO (an advisor has already been appointed with valuation in the $1bn area).

Asian credit

Chinese government entities are reportedly acquiring "golden shares" in certain subsidiaries of Alibaba and Tencent, which will provide the government with special rights over the business direction and strategy of the subsidiaries. According to SCMP, an entity of the Cyberspace Administration of China (CAC) has acquired a 1% stake in Guangzhou Lujiao Information Technology (GLIT), which is the digital media subsidiary of Alibaba. Through this stake, CAC has stronger control over the content in Alibaba's streaming video platform, Youku and the web browser UCweb. An official from CAC has been appointed a new board member at GLIT. A government entity in Shenzhen could take a similar stake in the media businesses of Tencent.

According to Xinhua News, China is drafting a 21-point plan to support high-quality property developers and mitigate their liquidity constraints. The plan reportedly may include speeding up the lending of CNY150bn of previously announced loans for home deliveries, an additional CNY200bn of special fund for the deliveries of residential properties as well as establishing a CNY100bn support plan for rental housing loans.

The Indian government is reportedly exploring the possibility of issuing INR-denominated green bonds to raise an equivalent of $2bn for sustainable projects, according to Bloomberg.

Emerging markets

Emerging market hard currency sovereigns enjoyed another week of positive returns (+1.57% as measured by the JP Morgan EMBI Global Index) as a result of spread tightening (-14bps) and a rally in US treasuries following the CPI print last week. African and Latin American names led the way as an improvement in market sentiment meant bonds traded higher.

The improved risk appetite was reflected across the asset class in different ways; EM bond funds saw their largest weekly inflows since April 2022. Several new deals were printed last week, mostly in the investment grade space and in ratings news, Fitch affirmed Poland at A- and Angola at B-.

In China, CPI printed in line with expectations at 1.8% y/y, as the nation continues to be insulated from surging inflation. The market is turning increasingly optimistic on China following support for the property sector, a softening of the government's stance on the technology sector and the re-opening of the economy. The market is now expecting a 4.8% 2023 GDP growth rate. As a result of its re-opening China has reported rising Covid-19 deaths, at an official death tally of 60,000 for the first 35 days of the current infections wave, thought there is speculation this figure may be much higher. Our Asia desk now expect cases to peak within 30 days.

Commodities

The commodity market recovered its losses from last week. Base metals continue to perform strongly with aluminium and copper rallying by 13% and 7.8%.

Nickel declined by 4.7% on the week as Tsingshan Holding (which crashed the market last year) has been ramping up production capacity and is in talks with struggling Chinese copper plants to re-purpose them to process nickel. The plan could add around a fifth to global nickel output.

Energy markets rallied on aggregate with WTI and Brent rallying by 8%+, natural gas prices (US and European) continued to decline. Positive news broke on the demand outlook for China with oil consumption expected to rise by 800,000 barrels a day to a record 16 million in 2023 following the re-opening of the economy.

Fixed Income Asset Allocation Views

16th January 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 become less attractive since November, technical and fundamentals moving sideways. **The group shifted negative on credit risk, downgrading Investment Grade and upgrading Structured Products and Emerging Markets.** ▪ We are past the peak of economic growth, with expectations for more 25bp hikes in 1H 2023, followed by multiple cuts in 2023. ▪ Uncertainty remains elevated due to fears surrounding recession probabilities, schedule of central bank hiking/easing, inflation, 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, 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 P€0 $£+1 +2 Long	▪ Longer yields to be captured by long-run structural downtrends in real yields ▪ Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures ▪ Hiking cycles may be curtailed by weakening growth, as risk of a policy error increases ▪ change in UK fiscal position to contractionary is a positive for the front end	▪ Inflationary dynamics become structurally persistent ▪ Labour supply shortage persists; wage pressure becomes broad and sustained ▪ Fiscal expansion requires wider term premium ▪ Long run trend in safe asset demand reverses
Currency ('E' = European Economic Area)	Short -2 -1 ¥ A$ EM $ €£ 0 +1 +2 Long	▪ 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))	Under-weight -2 -1 C0 R+1 +2 Over-weight	▪ 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	▪ EMD spreads tighter since last meeting; strong performance, even with in weaker credit quality names. ▪ 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 (outflows and supply) remain a headwind	▪ 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	▪ US & EMEA spreads have continued tightening to less attractive valuations as fundamentals and technicals are unchanged. ▪ Fundamentals remain stable, have yet to see expected deterioration – may be a 2023 story. ▪ Inflation, labor supply, low dispersion and monetary tightening continue to pressure margins and operating environment. Waiting for Q4 results and '23 outlooks.	▪ 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	▪ Spreads have continued widening. Combined with greater downside risks, the group prefers conservative position while open to attractive buying opportunities. ▪ Technicals have started to improve with positive fund flows and no defaults in October. Light primary market ▪ Bank loan market has moved sideways: greater volatility and fund outflows are offset by stable CLO formation and less new loan issuance. Concerns about recession and interest cost remain headwinds. No defaults since September, calendar is opening for higher quality issuers	▪ Default concerns are focused on demand destruction, margin pressure and macro risks ▪ Loan technicals & flows weaken ▪ Global consumer health weakens ▪ Russian invasion & spillover ▪ Commodity prices continue to retrace
Agency MBS	Under-weight -2 -1 0 ■+1 +2 Over-weight	▪ Mortgage spreads have widened in past month to the cheapest level in a decade; valuations and long-term fundamentals pushed the group to upgrade Agency MBSCurrent coupon spreads near recent wides ▪ Headwinds as money manager demand is small relative to Fed, bank, REIT and overseas selling pressure ▪ Looking to add as preference shifts to high quality assets	▪ 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	▪ 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 are attractive; moving to buy higher quality risk ▪ CMBS: Mostly solid fundamentals but weakening. Spreads attractive for historical CMBS, but better relval elsewhere. ▪ CLOs: Spreads modestly tighter, Mezz spreads firming along with macro. Default rate increasing. ▪ 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 ▪ Work From Home continues fullsteam-ahead post-pandemic (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	▪ Global Recession

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