In Credit

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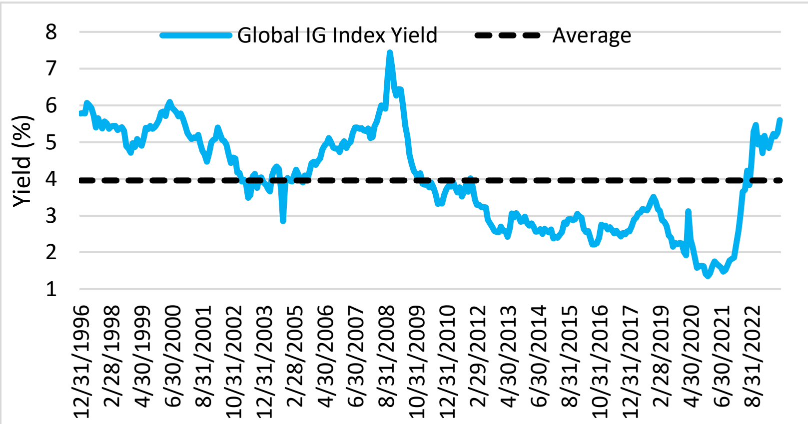
If you want yield, you got it.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.70%	-10 bps	-0.1%	-1.9%
German Bund 10 year	2.79%	-10 bps	0.6%	-0.6%
UK Gilt 10 year	4.46%	-11 bps	0.4%	-4.2%
Japan 10 year	0.76%	-4 bps	-0.1%	-0.6%
Global Investment Grade	137 bps	-1 bps	-0.1%	1.0%
Euro Investment Grade	158 bps	-2 bps	0.2%	2.5%
US Investment Grade	127 bps	-2 bps	-0.2%	0.2%
UK Investment Grade	134 bps	-1 bps	0.1%	1.3%
Asia Investment Grade	205 bps	10 bps	-0.1%	2.3%
Euro High Yield	486 bps	-8 bps	-0.2%	6.1%
US High Yield	430 bps	-3 bps	-0.7%	5.2%
Asia High Yield	929 bps	9 bps	-0.2%	-4.9%
EM Sovereign	378 bps	0 bps	-0.9%	0.1%
EM Local	6.8%	-11 bps	-1.0%	3.3%
EM Corporate	345 bps	7 bps	-0.6%	2.8%
Bloomberg Barclays US Munis	4.3%	-17 bps	0.6%	-0.8%
Taxable Munis	5.6%	-14 bps	-0.4%	-0.5%
Bloomberg Barclays US MBS	71 bps	6 bps	-0.5%	-2.7%
Bloomberg Commodity Index	238.37	2.8%	0.6%	-2.8%
EUR	1.0536	-0.7%	-0.6%	-1.8%
JPY	149.49	-0.2%	-0.1%	-12.3%
GBP	1.2176	-0.8%	-0.5%	0.5%

Source: Bloomberg, ICE Indices, as of 13 October 2023. *QTD denotes returns from 30/09/2023.

Chart of the week – Global investment grade index yield, 1996-2023



Source ICE Indices, Bloomberg, Columbia Threadneedle Investments, as of 30 September 2023.

Macro / government bonds

Last week we saw a tussle in fixed income markets between economic fundamentals, rising issuance and safe-haven bids.

Although the potential invasion of Gaza led to an immediate fall in bond yields in markets, in the absence of "boots on the ground" activity, market sentiment in the US treasury market turned back to economic fundamentals and rising issuance as we progressed through the week.

We also had the publication of the minutes from the US Federal Reserve, which provided context for where we are in the market cycle and a glimpse into the thought processes of policy makers, although their power to move the market was clearly diminished by events in the Middle East. The minutes pointed to a resilient economy, tight labour market and elevated inflation. The majority of members had voted to pause at the last meeting. Two core messages emerged from the minutes. First, the strength of the economy means we are in a higher for longer interest rate environment. Second, that the risks policymakers face are increasingly double sided, as they balance overtightening monetary policy versus undertightening. Voices from the Fed have been slightly discordant of late: while some policymakers have pointed to potentially one more rate rise while others have communicated that sufficient monetary tightening has already taken place – with the key rider of data dependency. Illustrating the latter point, US inflation data came in stronger than the market had expected, exerting upward pressure on domestic US bond yields, and bond yields internationally. US headline inflation came in at 3.7% YoY to the end of September, while core inflation came at 4.1%. Aside from the still elevated level of inflation, longer-dated bonds also face structural headwinds in terms of rising term premia and increased sovereign issuance in the US. Geopolitical tensions, however, trumped macro data over the course of last week. The yield curve flattened, as market participants placed their chips on the 10-year and the 30-year sector, as shorter-dated valuations offered limited scope for market upside.

If we split our macro views between duration and curvature, we remain modestly long duration across our portfolios. We are prepared to withstand the volatility of the end of the market cycle, as we anticipate a more benign environment for bonds, as domestic demand increasingly slows. The potential persistence of inflationary pressures, alongside rising term premia and rising issuance, has led us to combine a modest long duration position with yield curve steepening strategies across core markets.

Investment grade credit

In spite of plenty of economic news, stronger government bond markets and concern about a broadening in the conflict in the Middle East there was little reaction in credit markets where spreads were not much moved last week.

Three major US banks reported last week (JP Morgan, Citbank and Wells Fargo). These banks reported peaking margins (peaked at Wells), declining deposits especially Citi in North America. Asset quality that is normalising (deteriorating) and seen though rising deliquencies in commercial real estate at Wells Fargo and a modest deterioration in credit card charge-offs across the board amid tougher lending standards. Capital continues to rise and return on equity is running between 7% and 18%.

The credit market seems supported by historically high yields, reasonable spread valuations especially in Europe, declining new issuance in the fourth quarter and strong credit fundamentals – including improved credit ratings – and lastly the likelihood that the Fed, the European Central Bank and Bank of England will not increase rates materially from here. On the other side, expecations of lower growth in 2024 compared to 2023 and heightened geopolitical risk remain concerns. **Chart of the week** plots the yield of the ICE Global investment grade yield going back to 1996. Against an average of 4% the present yield of 5.6% appears attractive for those who seek income without too much risk. Quite a difference from the sub-2% yields found in 2020/2021!

High yield credit & leveraged loans

US high yield bond returns were positive over the week amid elevated rate volatility, limited new issuance, and continued retail fund outflows.

The ICE BofA US HY CP Constrained Index Returned 0.67% and spreads were unchanged. According to Lipper, retail high yield bond funds reported $2.5bn of outflows, the third consecutive withdrawal over $2bn. Meanwhile, the loan prices were stable with the average price of the J.P. Morgan Leveraged Loan Index largely unchanged over the week following a $0.60 decline over the previous two weeks. Retail loan funds saw $100m withdrawn.

European High Yield (EHY) had a solid week returning positive performance on the back of tightening spreads (8bps to 486bps) and falling yields (-0.12% to 8.13%), which also benefited from lower government bond yields. However, it was still another decompression, risk-off week as BBs outperformed with CCCs experiencing wider spreads and returning only 1/3 of BB's performance. Sterling high yield recovered its lead versus EHY as the former outperformed. Funds flows were negative (-€572m), the largest weekly outflow since July 2022, exiting via both ETFs and managed accounts. This brings the YTD outflow to €1bn. The corporate primary market was quiet last week with only a small €100m tap.

In sector news, there were more signs of weakness in the building sector. First, Travis Perkins lowered its 2023 outlook on the back of weak trading as the issuer saw deterioration over Q3. There has been a pronounced slowdown in new builds and housing. Price deflation is being seen in terms of commodity pricing. This was followed by news from CYG PLC (UK and northern Europe, roofing and building materials company), which cut its full year profit and sees revenue down in Q3. Residential new build was blamed as the primary driver for the fall.

In M&A news, Telecom Italia confirmed it had received a binding offer from KKR on the NetCo including FiberCorp. It has also received a non-binding offer for Telecom Italia's stake in Sparkle, a subsea cable unit. The big news in the UK was that some private equity groups have put in a bid for Stonegate Pubs, which has been on the market since early February 2023.

Structured credit

On the back of the rate rally, Agency MBS performed well last week. The sector was up 74bps. despite slightly wider spreads on a four day trading week. Prepayment data was released for September evidencing a slowing of speeds by approximately 17%. Seasonality and a lower day count are consistent factors however the primary culprit is higher interest rates. Total gross issuance was essentially flat at $94bn in September. It is estimated that only c1% of borrowers have the economic incentive to refinance, leaving the entire mortgage universe trading at a discount. This phenomenon has also impacted Fed paydowns, which declined to $16.8bn in September versus its $35bn cap.

In Non-agency, fundamental performance remains solid. While spreads are wider MoM, they remain attractive for the risk given more resilient home price appreciation. In contrast, the CMBS market continues to see higher delinquencies and downgrades as maturities struggle to refinance. This is mostly related to office while non-office sectors continue to perform as expected. As it relates to the overall US consumer, all eyes are on the looming impact of student loan repayments, which resume this month after a long period of forebearance. Some estimate that approximately 50% of borrowers will take advantage of the one-year on ramp, which gives them further reprieve.

Asian credit

The US Commerce Department has granted a waiver to both SK Hynix and Samsung Electronics to continue importing advanced equipment for their manufacturing plants in China on an indefinite basis without requiring further US approvals. TSMC has also been granted a one-year waiver to import equipment for their chip foundries in China.

The founding family of Country Garden has recently provided a $300m loan (interest-free) to the company. There are currently four unpaid coupon payments facing the upcoming expiration of 30-day grace periods. The grace period for the delayed coupon payment of $15.4m on the COGARD Sep '25s bond is on 17 October 2023.

In Indonesia, Medco Energi launched a tender offer for any or all of its 2025 bond (amount outstanding: $235m) and capped tender offers for its 2026, 2027 and 2028 bonds. Altogether, the company will buy up to $425m if the tender offers are fully taken up. The funding for the tender offer will come from a credit facility of up to IDR5.25trn (c$330m, 57-month tenor) and the proceeds of a rupiah denominated bond (IDR1trn). Medco also plans to issue a US dollar bond for other debt refinancing and funding a potential acquisition of a 20% non-operating interest in oil and gas assets in the Middle East.

The Supreme Court of India has postponed the hearing of the SEBI probe on the Adani Group by another week to 20 October 2023.

Emerging markets

EMBIG spreads were flat on the week with tightening in high yield credits offsetting the widening in investment grade. Recent outperformance has centred around the recovery of distressed stories such as Sri Lanka, which has recently agreed a restructuring agreement with China.

In Credit rating news, Uganda was downgraded to B- by S&P.

In Poland, the left leaning opposition coalition are projected to overthrow the right-wing Law & Justice party according to exit polls. The opposition, lead by former European council president Donald Tusk, is seeking to normalise relations with EU and secure €35bn+ in EU funding that was withheld due to lack of judicial independence. Despite Tusk looking likely to gain control, his majority will be slim and face strong opposition at high levels of government. The zloty gained as much as 1.8% on Monday morning.

In further election news, Ecuador has chosen Daniel Noboa as its next president. Noboa has pledged to tackle violent crime, unemployment and foster foreign investment alongside recommending tax exemption and incentives for new businesses. Violent crime related to cocaine trafficking has been on the rise with a previous anti-corruption candidate being assassinated in August.

Commodities

The BCOM index delivered a 2.8% total return thanks to gains in precious metals and energy.

Gold rallied by 5.2% on the week closing out at $1916 per Oz, versus all time highs of $1,969 back in March.

Crude also performed strongly, with WTI gaining by 6.4% to $97.4. Markets continue to be supported by supply risk in the Middle East on fears of an escalation of the conflict within the region and the prospect of restricted Iranian supply. Despite these concerns, OPEC+ has the benefit of excess spare capacity following recent production cuts.

Looking forward, the IEA amended its forecast for oil demand in 2024, expecting demand to rise by 880,000 barrels a day versus the previous expectation of a 1 million rise. This follows broadening economic concerns, EV adoption and energy efficiency measures. The 2023 demand forecast was raised by 100,000 barrels.

Responsible investments

The UN's SDGs have recently passed the halfway mark from when they were set to the end point in 2030. At the UN SDG summit at the end of September the key takeaway was that almost 50% of the goals are either moderately or severely off track. Canada's Prime Minister, Justin Trudeau (who is also Co-Chair of the Sustainable Development Goals Advocated group), said: "the SDGs are not a luxury, not some wish list generated by academics of global nice-to-haves. Rather, they are the building blocks of success in every community. It will only become harder and more expensive the longer the international community drags its heels." At a recent UN conference, UN Secretary General Antonio Guterres warned again that the world is "dangerously off track" to achieving the goals, and it was reported earlier this year that developing countries have a $4trn gap in SDG aligned investments.

Elsewhere, Gavin Newsom, Governor of California, has introduced a new law to require companies to disclose their carbon emissions in the next few years.

Fixed Income Asset Allocation Views

16th October 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 continue to be rich overall. Technicals seem stable following seasonal issuance; 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 possible hike left in the hiking cycle. 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 € 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	▪ 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.	▪ 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	▪ Disinflation under threat but intact; EM central banks still in easing mode. ▪ Real yields remain high. ▪ Selected curves continue to hold attractive risk premium.	▪ Sustained high core rates thwart EM easing cycles. ▪ Energy persistence derails disinflation trend. ▪ US outperformance strengthens US dollar. ▪ Structurally higher global real rate environment subdues risk assets
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Tighter financing conditions and slower trend growth demand higher risk premium ▪ Valuations unattractive in all but the lowest quality credits ▪ Slower EM policy easing dents 2024 growth expectations ▪ Continued outflows offset by negative net supply ▪ Focus on idiosyncratic opportunities where reform and fiscal consolidation upside not reflected in spreads.	▪ US soft landing, overly disinflation and moderating rate outlook ▪ Strong recovery in investor flows ▪ Carry and constrained supply overwhelms fundamental risks
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ US and EMEA spreads are at similar levels to last month; minor fundamental deterioration at a sector level, but management is positioning conservatively. EUR valuations are attractive; prefer USD and Euro to Sterling. ▪ Typical seasonal issuance to start Sept, but less than estimated and skewed towards the shorter end of the curve. Credit metrics are solid amidst recession uncertainty. Fundamental concerns remain focused on commercial real estate for Banking sector, tight labour supply, changing consumer behaviour.	▪ 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	▪ Spreads remain inside historic medians and are roughly unchanged since August. Technicals have been slow but stable, with more issuances in the pipeline. Fundamentals continue deteriorating slightly due to financial conditions, but with no significant impact so far outside of distressed names. ▪ Prefer conservative position; open to attractive buying opportunities in short HY & BB's and higher quality loans where financial conditions are less of a headwind. ▪ US HY defaults remain below historic averages, with further default expectations now being pushed into 2024. ▪ Bank loan market continuing May's rally, with overall market dispersion. Themes: moderating 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. ▪ Volatility in the short end of the curve, eroding potential upside where we are positioned for carry.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Mortgage index at similar lever to last month with spreads wide of historic medians, the group views agencies as attractive. ▪ Record low real estate transactions leading to low supply of new MBS. ▪ Place to add, prefer high coupon assets; constructive view over longer time horizon.	▪ Costlier funding and tighter lending standards from bank crisis ▪ Rising rates cause prepayments to normalise without reducing mortgage servicing. ▪ 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	▪ Our preference remains for quality Non-Agency RMBS ▪ RMBS: Home prices resilient despite headwinds, but with all-time low transaction activity. Delinquency, prepayment, and foreclosure performance remains strong; difficulty seeing deterioration of home prices given labor market strength. ▪ CMBS: We feel cautious, especially on office and multifamily. Delinquencies increasing as maturities come due. Credit curve remains steep. AAAs have mostly retraced post SVB widening, but BBBs remain at widened levels. ▪ CLOs: Pick up in new issuances leading to slightly tightened spreads. Defaults remain low. ▪ ABS: Attractive relval in some senior positions; higher quality borrowers remain stable, lower quality borrowers continue to underperform. 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 ▪ Student loan repayments weaken consumer spreads on a secular level. ▪ 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	▪ o/w Copper ▪ o/w Grains ▪ u/w Gold ▪ o/w Soybean Meal ▪ o/w Oil ▪ o/w Lead ▪ o/w Zinc	▪ Global Recession