In Credit

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Macro / Government bonds,
Investment Grade Credit

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Euro High Yield Credit

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US High Yield Credit,
US Leveraged Loans

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Emerging Markets

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Structured Credit

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Asian Fixed Income

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Responsible Investments
Investment Grade Credit

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Commodities
Emerging Markets

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General Fixed Income

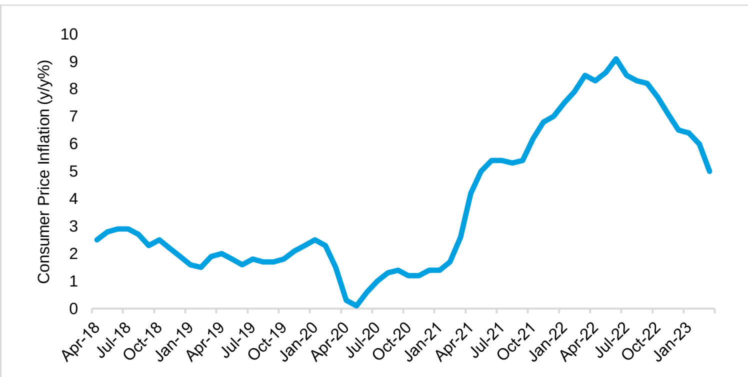
Disinflation week.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.51%	21 bps	-0.1%	3.0%
German Bund 10 year	2.43%	25 bps	-0.8%	0.7%
UK Gilt 10 year	3.64%	20 bps	-1.1%	1.1%
Japan 10 year	0.49%	1 bps	-0.5%	1.9%
Global Investment Grade	147 bps	-6 bps	0.1%	3.0%
Euro Investment Grade	159 bps	-8 bps	0.0%	1.6%
US Investment Grade	139 bps	-7 bps	0.2%	3.6%
UK Investment Grade	152 bps	-5 bps	-0.2%	2.2%
Asia Investment Grade	220 bps	-12 bps	1.0%	3.4%
Euro High Yield	475 bps	-34 bps	0.4%	3.4%
US High Yield	443 bps	-41 bps	0.7%	4.5%
Asia High Yield	722 bps	-21 bps	0.7%	3.7%
EM Sovereign	392 bps	-17 bps	0.6%	2.8%
EM Local	6.6%	5 bps	0.8%	6.0%
EM Corporate	364 bps	-16 bps	0.9%	3.1%
Bloomberg Barclays US Munis	3.1%	-2 bps	1.0%	3.8%
Taxable Munis	4.8%	18 bps	0.2%	5.6%
Bloomberg Barclays US MBS	65 bps	2 bps	0.0%	2.5%
Bloomberg Commodity Index	238.34	1.6%	2.4%	-3.1%
EUR	1.0972	0.6%	1.4%	2.7%
JPY	133.92	-1.5%	-0.7%	-2.0%
GBP	1.2386	-0.2%	0.6%	2.7%

Source: Bloomberg, Merrill Lynch, as of 14 April 2023.

Chart of the week: US Consumer Price Inflation rate, 2018-2023



Source: Bloomberg, Columbia Threadneedle Investments, as of 10 April 2023.

Macro / government bonds

It has been a tougher week for government markets as yields rose throughout the period.

This came despite weaker US consumer and producer price inflation data and lower import prices **(see chart of the week)**. All of which support the notion that inflationary pressures are receding. As the chart illustrates, consumer prices were rising at over 9% in June of last year but are now growing at under 5% y/y. US retail sales were also a miss relative to expectations as March retail sales fell 1.0% m/m, below consensus expectations of -0.4%.

The lack of further financial sector contagion and rising US consumer inflation expectations both dented sentiment for risk free assets.

Moreover, central bank rhetoric still points to further increases in interest rates in the US, Europe and probably the UK at upcoming meetings.

Investment grade credit

Credit markets enjoyed a strong week with spreads materially tighter since the weakness seen post the SVB, Signature and Credit Suisse bank failures. The Global investment grade index ended the week with a spread of 147bps. Spreads were as wide as 170bps in March according to index data from ICE.

Markets have been supported by lighter new issuance (ahead of the earnings season) with higher risk areas of the market performing most strongly.

The week ended with some of the US's major banks reporting solid earnings. JP Morgan, Citibank and Wells Fargo noted strong margins (despite higher deposit costs), resilient fee income from investment banking but negligible loan growth and normalising costs of risk. Capital and liquidity position were notably solid and ahead of regulatory requirements.

High yield credit & leveraged loans

US high yield bond valuations tightened over the week amid moderating inflation, reopening capital markets, and an improved stretch of retail inflows. The ICE BofA US HY CP Constrained Index returned 0.77% and spreads were 41bps tighter. April new issue activity, totalling $11.7bn, has already more than doubled March's volume amid a multi-month low for yields. According to Lipper, retail high yield funds saw a $235m outflow. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index rose $0.10 over the past week to $94.03 and has now recouped $0.99 of a $1.54 decline between 3 September 2022 and 24 March 2023 as valuations continue to benefit from receding banking stress, a dearth of supply, and a US Federal Reserve likely approaching the end of its tightening cycle in May. Retail loan funds saw their 33rd weekly outflow over the last 34 weeks with $461m withdrawn.

European high yield had another positive week (return of +0.34%) due to a tightening of spreads (-34bps to 475bps) as rising government yields meant the yield fell only 6bps to 7.64%. Market liquidity was fair with good demand from ETFs while real money showed some pressure on more interest sensitive BBs. The asset class experienced net outflows (-€116m) given that managed accounts were seen selling the higher rated credits. The primary market was quiet but with talk of a big pick-up in activity coming in the next few weeks though these will likely focus on refinancings.

In stock specific news, Lottomatica announced plans for an IPO in Milan, with proceeds to be used for debt repayment at the holding company level. Adler, the German real estate group, has had its restructuring finally approved by the UK courts: the company can now look for new funding from new investors.

In credit rating news, Asda was downgraded to B2 from B1 at Moody's. The move reflects weaker operating performance in 2022 as the company absorbed cost inflation and leverage above expectations. There was also news that ASDA will be buying EG Group's Irish and UK forecourt business.

Asian credit

The AI (artificial intelligence) space in China is in the limelight with various companies such as Alibaba and Sensetime recently announcing the roll-out of AI-powered applications. The Cyberspace Administration of China (CAC) also announced the draft notice on generative AI and the public feedback process is open until 10 May 2023. The draft notice contains 21 guidelines that cover, among others, the respect of intellectual properties (IP), prevention of discrimination, responsibility for the training data, labelling rules and adherence to the cybersecurity law and other domestic data protection laws (such as the data security and the personal information protection law).

The outcome of the mid-term review (MTR) for Adani Electricity Mumbai Ltd (AEML) was positive with the MERC (Maharashtra Electricity Regulatory Commission) giving its approval for tariff adjustments. AEML will receive INR15.74bn (principal of INR14.96bn + carrying costs) from the "past period revenue gap" over the next two years, which is almost the entire amount claimed by AEML.

The India government has revised the gas pricing framework by implementing the recommendations of the Kirit Parikh Committee, which will result in a more stable pricing regime, and is a positive for ONGC and Oil India. The domestically produced gas will be priced at 10% of the monthly average of the Indian Crude Basket (ie, imported crude), with a floor of $4/mmbtu and ceiling of $6.5/mmbtu. While the price ceiling caps future upside, the floor provides downside protection for ONGC.

Structured credit

Returns in Agency MBS were dismal last week alongside other rate sensitive asset classes. The sector was down 1.11% over the 5-day period. The move in rates was primarily the culprit as spreads tightened on a relative pick-up in liquidity. BlackRock, on behalf of the FDIC, announced its plan to liquidate the book of securities assumed from the rescued regional banks. Approximately $1.5-2bn a week of Agency MBS and another $300-500m of CMOs will be targeted subject to market liquidity and trading conditions. The announcement quelled negative sentiment for the asset class as investors feared bonds would be dumped in quick succession. In CMBS, activity was modest as two private label deals priced last week, which brings YTD volume down 80% y/y. Spreads were modestly tighter in both primary and secondary trading. The upgrade / downgrade ratio continues to point towards significant deterioration with a 1:4

ratio. It was a quiet week in ABS with only three new issues priced. Spreads were unchanged. The trend in tighter lending standards remains.

Emerging markets

Emerging market hard currency sovereign spreads tightened 10bps over the week, contributing to an overall return of +0.13%. High yield countries outperformed investment grade, particularly in Africa.

There was little central bank action last week with just South Korea meeting and voting to hold rates. We expect the theme of pausing rate hiking cycles to continue now as more countries see their inflation figures start to decline.

Last week we also had the IMF's World Economic Outlook (WEO). The release saw 2023 global growth downgraded to 2.8% from 2.9% since the January update. For emerging markets there is some encouragement; firstly, the emerging market GDP growth rate for 2023 is expected at 3.9% vs 1.3% for developed economies, the gap at which EM outgrows developed markets is expected to return. Secondly, since the last WEO database was released back in October, we have had selected 2023 growth upgrades for Mexico (+0.7%), China (+0.8%) and the Philippines (+1.0%), as the Asian growth outlook remains very strong.

Elsewhere in EM, China has injected a net 20bn yuan of liquidity into the banking system through the medium-term lending facility, as the government retains its pro-growth stance. In Africa, Ghana is looking to secure financing assurances from creditors to meet IMF demands for a $3bn loan. In Pakistan, the government has secured $1bn in support from the UAE, in attempt to unlock a $1.1bn tranche of the $6.5bn IMF bailout.

Commodities

The BCOM index returned 1.6% lead by gains in industrial metals and energy.

Energy markets were buoyed by a 5.9% rally in US natural gas, which is still trading at very low levels relative to recent history. In Crude, brent prices rallied 1.4% with prices closing out the week at $86 a barrel. In crude news, the EIA announced a bullish prediction of crude demand, hitting a record 101.9m barrels a day in 2023. The EIA already expected a supply deficit to emerge in the second half of the year prior to the recent surprise 1m barrels a day production cut from OPEC+.

Base metals rallied 2.9% on aggregate with nickel (+5.7%) and lead (+3.7%) delivering the largest returns.

Grains delivered modest gains amidst the comments from the Russian Kremlin that the outlook for the Ukrainian grain corridor is “not so great”. The corridor represents 50-60% of Ukraine's corn and wheat exports. Russia has several demands for the extension of the corridor (post 18 May) including the removal of export barriers to Russian grains and fertiliser, and the reconnection of Russia's agricultural bank to the SWIFT payment system.

Fixed Income Asset Allocation Views

17th April 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 gotten more attractive during the month, although at the expense of mixed technical and deteriorating fundamentals. **The group remained negative on credit risk, downgrading IG and EM** ▪ The Fed Funds market is pricing in a peak of 4.99% and rates being cut to 4.37% in 2023. This pricing has been especially volatile over the past three weeks. ▪ 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. Risk skewing to slightly higher. ▪ Uncertainty remains elevated due to fears surrounding banking crisis, 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 with no labour softening, banking crisis eases with no 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.
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)	¥ A$ EM 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 widened along with other risk assets, technical have worsened. ▪ China reopening optimism continues to be a tailwind. ▪ Fundamental headwinds: 22/23 growth deltas very large, elevated fiscal deficits, rising debt to GDP ratios, significant inflation, LATAM political risks, difficult global financing conditions (US rates and USD strength), 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 from early March; fundamentals are weaker and technical challenges returned. EMEA valuations remain cheap to USD and there is a preference for European credit. ▪ Fundamentals had a strong starting point in 2023, however the banking crisis and spill over risk is pressuring the market. ▪ Inflation, labor supply, low dispersion and monetary tightening continue to pressure margins and operating environment.	▪ Additional bank failures with too little governmental intervention ▪ 2023 supply 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 moved wider from early March during the banking crisis, with fundamentals and technical weaker. Prefer conservative position while open to attractive buying opportunities, especially in short HY. ▪ Bank loan market has widened along with other credit sectors. Concerns about recession/weakening economy and interest cost remain headwinds.	▪ 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 widened along with other risk assets. Since February, the group had modestly reduced exposure due to outperformance. ▪ Performance remains stable despite March's higher volatility driven by the banking crisis and heightened monetary policy uncertainty. ▪ Place to add, prefer high quality and higher coupon assets; constructive view 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	▪ Our preference remains for quality Non-Agency RMBS ▪ RMBS: Higher mortgage rate is headwind for prepays, fundamentals and transaction activity. Delinquency performance remains strong, need labor market weakness to see housing deterioration. Risk premiums still cheap. ▪ CMBS: Mostly solid fundamentals but weakening. Prefer Single Family Rental with its favorable 2023 supply outlook. ▪ CLOs: Spreads wider since Feb. Downgrades outpacing upgrades. Increased tail risks for subordinate bonds ▪ ABS: Lower income, renters, lower fico borrowers continue to underperform; higher quality borrowers remain stable.	▪ Weakness in labor 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 ▪ o/w Wheat ▪ u/w Corn	▪ Global Recession