In Credit

17 July 2023

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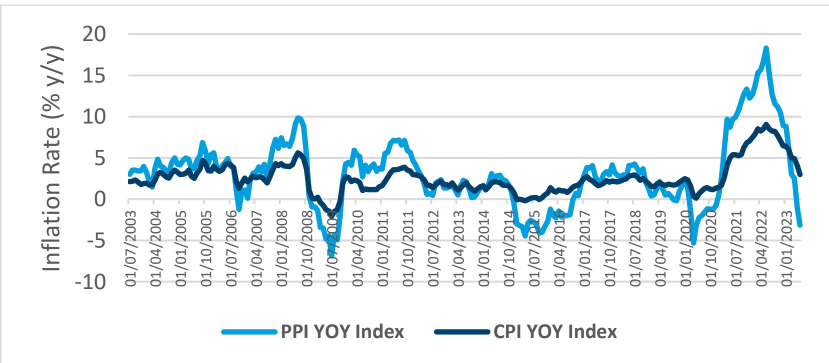
Three letters that mattered last week.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.79%	-28 bps	0.1%	1.8%
German Bund 10 year	2.46%	-17 bps	-0.5%	0.6%
UK Gilt 10 year	4.40%	-25 bps	-0.5%	-4.3%
Japan 10 year	0.48%	5 bps	-0.9%	1.8%
Global Investment Grade	136 bps	-1 bps	0.3%	3.1%
Euro Investment Grade	150 bps	-5 bps	0.4%	2.5%
US Investment Grade	128 bps	0 bps	0.3%	3.6%
UK Investment Grade	137 bps	-5 bps	0.6%	-0.5%
Asia Investment Grade	203 bps	11 bps	0.8%	3.9%
Euro High Yield	448 bps	-12 bps	0.5%	4.9%
US High Yield	390 bps	-18 bps	1.1%	6.6%
Asia High Yield	820 bps	3 bps	-0.5%	-0.7%
EM Sovereign	351 bps	-12 bps	1.0%	4.9%
EM Local	6.3%	-10 bps	2.5%	10.4%
EM Corporate	344 bps	7 bps	0.5%	4.1%
Bloomberg Barclays US Munis	3.5%	-7 bps	0.2%	2.8%
Taxable Munis	5.0%	-22 bps	0.0%	5.1%
Bloomberg Barclays US MBS	52 bps	-3 bps	0.3%	2.1%
Bloomberg Commodity Index	233.70	2.7%	3.3%	-4.8%
EUR	1.1235	2.4%	2.9%	4.9%
JPY	138.30	2.5%	4.0%	-5.5%
GBP	1.3081	2.0%	3.1%	8.4%

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

Chart of the week: US Consumer & Producer Price Inflation (2003-23)



Source: Macrobond, Columbia Threadneedle Investments, as of 10 July 2023.

Macro / government bonds

Three letters mattered last week: CPI.

And they mattered because they potentially threw some more light on when the US Federal Reserve could call a halt to its tightening campaign. They also mattered because a fall in inflation back towards target will necessitate less monetary policy medicine, thereby increasing the potential for a softer landing, which is good for risk assets.

Headline US CPI (which includes energy) came in at 3% on a year-on-year basis for June – 1 % lower than the prior month figure of 4%. Declining energy prices, which fell -1.2%, were the reason for the fall in inflation. In contrast, services inflation, although still elevated at 3.5%, continued to edge lower. Core inflation (which excludes energy and food) came in at 4.8% on a YoY basis This was lower than market expectations of 5% and lower than the prior month's reading of 5.3%. The inflation data led to a sharp reversal in US treasury yield levels. At the 2-year maturity point, yields fell 9bps while at the 10-year maturity point, yields fell 16bps over the week. Renewed bullish sentiment towards global bonds translated into their best week since November 2022; the Bloomberg Global Aggregate Index returned 2.3% for the week. The reversal in US treasury yields, although significant was also deceptive, bringing 10-year yields back to the middle of their current trading range of 4.1 % to 3.7%.

Internationally, a similar pattern could be seen to emerge. One market to perform particularly strongly was the higher beta UK government bond market, which had been trading cheap relative to other developed sovereign bond markets. Traders not only looked across to US inflation data, but also to local data on UK unemployment, which rose from 3.8% to 4%. US producer price data also surprised to the downside, coming in at 0.1% (annualised) for June. This reflected normalising global supply chains, stabilising commodity prices and a broader shift in consumer demand towards services and away from goods. Thomas Barkin, voting member of the FOMC, sounded a word of caution on the inflation data, making the point that if you back off too soon, inflation can come back strong, which would require the Fed to do more. It was a simple message of data dependency. While a July rate rise from the Fed appears a “slam dunk,” any concerted softening in inflation data could make this the last rate hike of the current cycle – a view presently reflected in market pricing.

Investment grade credit

The corporate bond market continues a trend of gradual spread tightening that has taken the global index spread from 170bps over government bonds in March to 136bps by mid-July. Market performance was supported last week by the subdued consumer and producer price reports out of the US **(see chart of the week).** The market is also being supported by inflows into the market and a typically light summer primary market.

As usual, the major banks opened the US results season with JP Morgan, Citigroup and Wells Fargo all reporting on Friday of last week. The banks presented a mixed to negative picture from a credit perspective. Profitability was at or above 2019 levels, but margins are now 'on the turn'. Asset quality is normalising with a deterioration coming through from credit card and commercial real estate exposure. Deposits are reducing as quantitative tightening continues, while loan growth is muted. Liquidity coverage is reasonable though lower than in Europe.

This week brings a raft of corporate results including Netflix, Tesla, IBM as well as the rest of the major US banks (Bank of America, Morgan Stanley and Goldman Sachs).

High yield credit & leveraged loans

US high yield bond spreads approached their YTD lows (+405bps), and yields decreased by the widest margin since January over the week amid soft inflation data and lower-than-expected initial claims. The yield-to-worst of the asset class decreased 47bps to 8.31%, the largest five-day tightening since January and the lowest yield since 8 February 2023. ICE BofA US HY CP Constrained Index returned 1.70% and spreads were 17bps tighter. According to Lipper, retail high yield bond funds reported a $379m outflow for the week. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index increased to a new 13-month high of $94.90. The loan asset class also continues to benefit from more balanced retail flows and a slower pace of new supply. Retail loan funds saw a $137m withdrawal.

It was a strong week for European High Yield (EHY) as performance was up +74bps both from narrowing credit spreads (-12bps) but also falling underlying government bond yields. EHY saw yields fall to 7.71% (-26bps): BBs outperformed (+0.81%) with single Bs not far behind while CCCs trailed, down -0.20%. Sterling high yield outperformed EHY for the second week in a row. Inflows into the asset class continued to improve, with the week seeing a pick-up across both ETFs and managed accounts. The primary market was reasonable with three issues totalling €1,350m, one of which was Telecom Italia (€750m).

EHY default rate rose 94bps to 1.36% over the second quarter, running at 2.6% annualised YTD. Recovery rates continued to fall, now at 42%, slightly above the long-term average.

In credit rating news, in the telecom sector Matterhorn Telecom was upgraded by S&P to BB- just as Fitch assigned a new BB+ rating. Moody's still has this at B+. In the auto sector, Ford was upgraded to Ba1 by Moody's on expectations of a marked improvement in its automotive EBITA margin and cashflow.

The Casino Group (French retailer) story looks like it is finally ending. Of the two interested parties, the French consortium has now pulled its offer leaving Daniel Kretinsky, the Czech entrepreneur, as the only bidder. He has also improved his offer by reducing the equitization of secured debt to €1.3bn (from €1.5bn), while the equity portion has been reduced to €1.2bn (from €1.35bn).

Finally, the week closed with a new scandal as Armando Pereira, co-founder of Altice Europe, was arrested on Friday on suspicion of fraudulent transactions, money laundering and tax evasion in connection with Altice Portugal. The firm also announced that it had suspended the current chairman Alexandre Fonseca.

Structured credit

The US Agency MBS market posted outsized positive returns of +1.73% on the week as spreads and rates rallied on lower-than-expected CPI data. The duration sensitive asset class benefited with 10-year US treasuries rallying 30bps and increased investor demand. On the housing market front, data was released for the month of May showing that home prices remain elevated. Prices increased YoY by 1.4% and were 0.9% higher than April 2023. CoreLogic estimates that home prices will continue to rise another 4.5% over the coming year. Rising home prices are despite mortgage rates that are back to November 2022 highs. While affordability is dismal, sellers are staying put as they locked in ultra-cheap financing during the pandemic.

In non-agency RMBS, spreads have tightened significantly since the end of June, and even more so post-CPI. ABS and CMBS spreads were firm to tighter on the week as well as reflecting an improved market tone.

Asian credit

In China, PBOC and the National Financial Regulatory Administration (NFRA) made a joint announcement, which expanded on the 16-point notice first released in November 2022 that laid out a plan to ensure the stable and healthy development of the property sector. Among others, the latest announcement includes updates for Point 4 (loan extension) and Point 8 (special project loans). For Point 4, the regulators encourage financial institutions to extend loans that are maturing before end 2024 by one year at commercially viable terms (previous: extensions for loans maturing before May 2023). For Point 8, there would be no downgrade of risk classification during the loan period for special project loans that mature before end 2024.

In India, JSW Steel Ltd is reportedly considering a potential bid for as much as a 20% stake in the coking coal business of Teck Resources Ltd for around $2bn. Adani Green Energy Limited reported robust growth in Q1 (period ended 30 June 2023). Energy sales volume rose 70% YoY to 6,023 million units, largely thanks to the increase in operational capacity (+43% YoY to 8,316 million units).

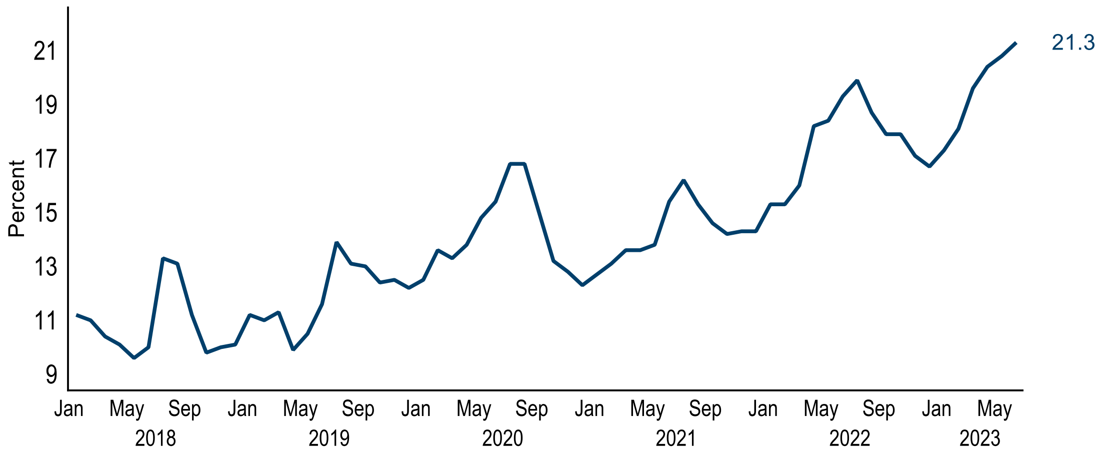
The Court of Appeals in the Philippines has granted the consolidated petitions of San Miguel Energy Corp and South Premiere Power Corp (SPPC), which allows SPPC to terminate its loss-making power supply agreement with Meralco. San Miguel Corp/SPCC will be looking out for new rounds of CSP (Competitive Selection Process), probably in late 2023 or early 2024, to bid for longer-term contracts with Meralco at rates that reflect market conditions.

Emerging markets

A rally in US treasury yields coupled with further spread tightening led to emerging market hard currency bonds returning +2.25% over the week. Spreads compressed a further 12bps taking the index level to 351bps over US treasuries. High yield spreads have compressed significantly to investment grade spreads as a result of the rally seen in lower-quality distressed names in the universe. One of which is Pakistan whose credit rating was upgraded one notch to CCC by Fitch. Pakistan reached a Staff-Level Agreement with the IMF last month and has been able to implement some reforms, which will improve its fundamentals.

Second chart of the week: Chinese youth unemployment (2018–2023)

China, Unemployment, Urban Surveyed Unemployment Rate, Aged 16 to 24



Source: Macrobond, NBS and Columbia Threadneedle Investments

China's Q2 GDP figure was worse than expected at 6.3% YoY, this was mainly attributed to the country's ailing property sector. Youth unemployment also hit a high at 21.3% **(see second chart of the week**) and is only expected to go higher over the coming months as more students graduate. There is growing discontent amongst young people over a lack of jobs available and more graduates are becoming vocal online, raising the potential for social unrest if the policy response does not deliver.

Commodities

The BCOM index had a strong week delivering total returns of 2.7%. The rally was broad based but led by rising industrial metal and grains prices. The US dollar priced commodity complex was supported by a 2.3% decline in the dollar following the US CPI undershoot.

In grains, Russia announced the Ukrainian grain export deal has stopped, and they will no longer co-operate with the deal. The deal has up to this point allowed the export of 33m metric tonnes of food, mainly to developing nations. If this persists this a negative for food price inflation as there is concern this will lead to a reduction in Ukrainian planting thanks to the increased costs of export for farmers.

The rally in industrial metals was led by gains in aluminium (+6%) and copper (+4%). Copper prices hit a three-week high last week. Base metals are under pressure as of Monday morning following weak data from China's property sector, which included property investment declining 7.9% for the first six months of 2023.

Fixed Income Asset Allocation Views

17th July 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 have tightened recently but remain wide of February's market. Technicals have stabilised, fundamentals remain a headwind. **The Group leans negative on Credit risk overall favouring higher quality sectors.** ▪ The Fed Funds market is pricing in a peak of 5.3% and rates being cut to 5.0% in 2023. This market has been volatile, with the first full cut now priced for Nov. ▪ The CTI Global Rates base case view is no cuts in 2023, and possibly one more hike during the summer. Expect the Fed to hold steady in 2H 2023. Focus remains on wages, financial conditions, and inflation expectations. ▪ Uncertainty remains elevated due to fears surrounding banking crisis spill over, monetary policy schedules, recession probabilities, persisting inflation, weakening consumer profile and ongoing geopolitical tension.	▪ Upside risks: the Fed achieves a soft landing with no labour softening, banking crisis eases with no lasting changes to fundamentals, consumer retains strength, end of Russian Invasion of Ukraine ▪ Downside risks: additional bank failures, simultaneous low unemployment, high inflation, hiking and slowing growth cause a recession. Russian invasion spills into broader global/China turmoil. 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 ▪ 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 beginning to tighten from March wides.. Technicals remain weak ▪ Maintaining conservative positioning while open to select idiosyncratic or relval based buying opportunities. ▪ Tailwinds: Central bank easing in less inflationary countries. ▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, increasing use of IMF programs, geopolitical risks, domestic political uncertainty.	▪ China/US relations deteriorate; China reopening less stimulating than hoped. ▪ Issuance slows ▪ Chinese reopening paused ▪ Spill over from Russian invasion: local inflation (esp. food & commodity), slow global growth. ▪ Persisting COVID growth scars hurt economies & fiscal deficits
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ US spreads have tightened & EMEA spreads unchanged since last month; Fundamentals and Technicals still weak to pre-COVID. EUR valuations are cheap, prefer USD and Euro to Sterling ▪ May issuance mostly in longer end of curve. Earnings resilience with deteriorating credit metrics point to idiosyncratic opportunities. Fundamental concerns remain focused on commercial real estate for Banking sector, tight labour supply, weaker consumer, recession concerns.	▪ Additional bank failures with too little governmental intervention ▪ Volatility remains high and 2023 supply isbelow 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 tightened since early May, fundamentals and technical remain unchanged, with beginning of June reversing May outflows. ▪ Prefer conservative position while open to attractive buying opportunities, especially in short HY & BB's. ▪ US HY defaults higher than last year but still at reasonable levels, possibly normalising to historic trends. ▪ Bank loan market has widened along with other credit sectors. Themes: retail fund outflows, rising defaults, limited issuance, credit concern in lower quality loans	▪ 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 remain wide to historic levels, the group sought to capitalise on Mya's weakness. ▪ Supply below expectations but improving. FDIC liquidations from Banks nearly half done. ▪ Place to add, prefer high quality and higher coupon assets; constructive view over longer time horizon	▪ Additional bank failures ▪ 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
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 remain resilient despite headwinds. Delinquency, prepayment, and foreclosure performance remains strong; need labor market weakness to see housing deterioration. Risk premiums still cheap to LT avg. ▪ CMBS: We feel cautious, especially on office and multifamily. Credit curve is very steep; non-office sectors remain stable ▪ CLOs: Spreads have widened slightly since May. Downgrades outpacing upgrades. More tail risks for subordinate bonds ▪ ABS: Attractive relval in some senior positions; higher quality borrowers remain stable. Market is active	▪ 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 ▪ WFH continues in 2023 (positive for RMBS, negative for CMBS). ▪ Rising interest rates dent housing market strength and turn home prices negative in 2023 ▪ Cross sector contagion from CRE weakness.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper ▪ o/w Oil ▪ o/w Grains ▪ u/w Silver ▪ u/w Gold ▪ o/w Aluminium ▪ o/w Soybean Meal ▪ o/w Corn ▪ o/w Lead	▪ Global Recession