COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

18 September 2023

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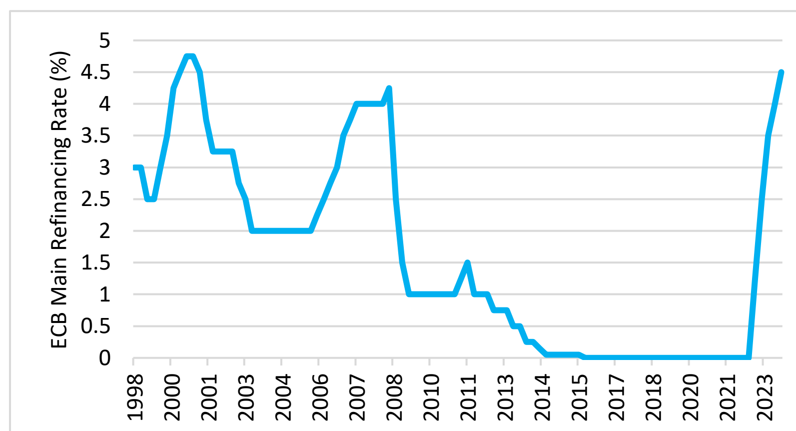
To infinity and beyond.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	4.34%	8 bps	-2.1%	-0.5%
German Bund 10 year	2.68%	7 bps	-1.5%	-0.3%
UK Gilt 10 year	4.37%	-5 bps	0.1%	-3.7%
Japan 10 year	0.72%	6 bps	-2.7%	0.0%
Global Investment Grade	131 bps	-2 bps	-0.6%	2.1%
Euro Investment Grade	145 bps	-7 bps	0.7%	2.8%
US Investment Grade	122 bps	-1 bps	-1.4%	1.8%
UK Investment Grade	131 bps	-3 bps	2.4%	1.3%
Asia Investment Grade	202 bps	-1 bps	-0.3%	2.8%
Euro High Yield	437 bps	-20 bps	2.3%	6.7%
US High Yield	379 bps	-6 bps	1.6%	7.1%
Asia High Yield	943 bps	0 bps	-3.7%	-3.9%
EM Sovereign	350 bps	-2 bps	-0.6%	3.2%
EM Local	6.5%	4 bps	-1.3%	6.4%
EM Corporate	330 bps	-2 bps	0.4%	4.0%
Bloomberg Barclays US Munis	3.9%	3 bps	-1.4%	1.2%
Taxable Munis	5.4%	6 bps	-2.8%	2.1%
Bloomberg Barclays US MBS	55 bps	1 bps	-2.0%	-0.2%
Bloomberg Commodity Index	242.74	1.4%	7.1%	-1.2%
EUR	1.0666	-0.4%	-2.3%	-0.4%
JPY	147.65	0.0%	-2.4%	-11.3%
GBP	1.2381	-0.7%	-2.5%	2.5%

Source: Bloomberg, ICE Indices, as of 15 September 2023.

Chart of the week – Euro interest rates, 1997-2023



Source: Bloomberg, Columbia Threadneedle Investments, as of 18 September 2023.

Macro / government bonds

Another week, another ratchet higher in interest rates.

The major macro news was a 0.25% interest rate hike to 4.5% by the European Central Bank, **(see chart of the week)** nudging the German 2-year yield higher to 3.2%. Changes to the ECB's macroeconomic projections, provided justification for the interest rate move. The September macro projections saw the ECB increase its inflation projections over those produced in June to 5.6% and 3.2% respectively – 0.2% higher. The ECB also lowered its growth projections by 0.2% to 0.7% for 2023 and by 0.5% to 1% for 2024. Higher inflation expectations reflected the recent pick-up in energy prices while the catalyst for lower growth had been the dampening impact on demand of tighter monetary policy. Christine Lagarde, President of the ECB, at the accompanying press conference said that although inflation continues to decline it remains too high. She tried to frame the central bank's action in terms of level and duration. Her core message was that rates would be set at a sufficiently restrictive level for a sufficiently long duration to return inflation to 2%. Despite the "higher for longer" message, the market nudged forward its expectation of the first rate cut from June to April of next year, as traders bet that worsening economic conditions, alongside expected continuing downward pressure on inflation, would cause the ECB to re-assess its current restrictive stance.

In the US, there was little real change in bond yield levels with the 2-year and the 10-year anchoring close to 5% and 4.3% respectively, as markets awaited the outcome of the US Federal Reserve's next policy setting meeting on 20 September. Core US inflation edged lower from 4.7% to 4.3% in August largely due to year-on-year declines in energy and commodity prices, although services inflation remained elevated. The relative resilience of the US economy, and widespread acceptance in the market that the Fed was unlikely to pivot to easier monetary policy in the near-term, provided support for the greenback against a broad range of currencies.

The UK continued to see a retracement in yields, with the yield on the 10-year gilt declining from 4.5% to 4.4%, as expectations of sluggish economic growth led to further inversion of the yield curve. Pricing in the swaps market indicated that the market had brought forward its expectations of the first cut in interest rates in the UK from September to March of next year.

Investment grade credit

Investment grade spreads tightened by a couple of basis points last week, even as the ECB raised rates once again (see above). Spread volatility has been uncharacteristically low these last few weeks and after the bank induced volatility earlier this year.

The global investment index spread is trading at 131bps over government bonds according to data from ICE Indices, so spreads are right on their five-year average and a couple of basis points tighter than the 20-year norm. At this level spreads are 11% tighter than at the start of the year with both euro and US spreads closely aligned at 13% and 12% tighter respectively. Sterling spreads have performed even better than this and are over 20% tighter year to date.

Looking across industry sectors, media and autos have performed best with banking and insurance lagging after weakness earlier in the year. The performance of cyclical sectors has been underpinned by rising economic growth expectations this year.

High yield credit & leveraged loans

US high yield spreads tightened to a low since April 2022 (+390bps) amid optimism the Fed can pause its policy hike campaign and successfully engineer a soft landing.

As well, this week's $9.6bn of high yield bond issuance was the heaviest since November 2019 amid improving capital market conditions. The ICE BofA US HY CP Constrained Index returned 0.20% and spreads were 7bps tighter. According to Lipper, retail high yield funds reported an $81m inflow, the third consecutive weekly inflow, albeit modest in size. Meanwhile, the average price of the J.P. Morgan Leveraged Loan index rose $0.31 w/w to a high since May 2022 ($96.18), with outperformance in discounted / lower-quality credits amid an active primary market, few macro surprises, and the asset class's largest weekly retail inflow since May 2022. Retail loan funds saw their fourth inflow in five weeks with $343m contributed.

European High Yield continued its market rebound as the asset class returned 0.55% last week with spreads tighter by 20bps to 437bps and yields lower by 12bps to 7.67%. Higher beta CCCs strongly outperformed, supported by more market positive view of Altice (French telecom) on comments of potential disposals. Still outflows from the asset class increased last week with €272m exiting, via both ETFs and managed accounts, especially for the EHY that is part of global high yield managed accounts.This now takes the YTD figure to a net outflow of €87m. The primary market, while open, remains on the light side of what was had been suggested for the start of the school season. Last week saw two new euro issues (Coty and Banijay), totalling €940m. For a change, the two issues are in the single B rating category.

There was more unfortunate news in the real estate sector as the Swedish financial watchdog announced a formal investigation into Alecta's (Swedish pension fund) investment in Heimstaden Bostad, questioning whether correct investment procedures were followed. This puts the fund, again, in the regulator's sights following a $2bn loss in US banks earlier this year.

There were credit rating changes in the leisure sector as Accor, the hospitality group, was upgraded by S&P to BBB- on strong operating performance. This puts the issuer on par with Fitch's upgrade (April 2023) and will take the issuer out of the EHY index. There was also an upgrade by Moody's for Royal Caribbean, by two notches, to B1. Nevertheless, this rating trails S&P's rating to BB- (from B) upgrade last month.

Even as there has been good demand for new issues, price remains key. FNAC Darty, French consumer products group, was touted as looking to refinance a 2024 bond. In the end, the deal was pulled given the financing price was on the high side of what it was willing to consider.

Asian credit

Moody's lowered its outlook for China's property sector from stable to negative due to weaker economic growth and an expectation that nationwide contracted sales will decline around 5% over the next 6-12 months. Homebuyers continue to be concerned over the timeliness of project completion, so the reduction of minimum mortgage requirements is a significant measure by the government to support property demand, Moody's expects the impact of the policy stimulus to likely fade after a few months, particularly in lower-tier cities and weaker economic areas.

The National Bureau of Statistics released macro activity data for August with above-consensus industrial production (IP) and retail sales growth numbers. In August, IP growth was 4.5% y/y (July 2023: +3.7% y/y) and retail sales growth was 4.6% y/y (July 2023: +2.5% y/y). Fixed asset investment growth, however, was below consensus at 2% y/y despite being an improvement from July (1.2% y/y).

In response to the soft macro environment, the PBOC cut the RRR (reserve requirement ratio) by 25% to a weighted average level of 7.4%, which is the second reduction this year. This will effectively inject around $69bn into the interbank market. Additionally, the PBOC also injected around $26bn (CNY191bn) via the 1-year MLF (medium-term lending facility) but it kept the MLF rate unchanged.

Emerging markets

Higher US treasuries once again constrained EM sentiment and the JP Morgan EMBI Global Index returned -0.17% over the week. Longer duration assets within the index, typically investment grade issuers, unsurprisingly fared the worst as US yields move higher.

There has been a recent pick-up in supply following a sustained period of muted primary market activity this year. While the increased supply was anticipated, the lack of new issue premium on offer (because of demand), as well as the high volume of issuers, has resulted in these deals performing poorly.

There are a lot of central bank meetings on the agenda this week: we expect policy makers in Asia to keep rates on hold while there could be further hikes in Turkey and another cut in Brazil.

In Peru, the central bank delivered its first rate cut since the onset of covid-19 (25bps to 7.5%). Peru now joins the likes of Brazil, Chile, Costa Rica who have also begun cutting rates. Peruvian inflation dropped to 5.6% (target 1-3%) in August following mass unrest and the nation entering a technical recession. Peru's agriculture has also been adversely affected by El Nino.

In Russia, the central bank unexpectedly hiked rates by 100bps to 13% with policymakers flagging they will consider further rate increases in upcoming meetings. This follows further pressure on the ruble, which is down 23% against the US dollar this year.

Commodities

The BCOM index rallied by 1.1% on aggregate with industrial metals (+1.3%) and energy (+2.2%) performing the strongest; the only negative sub-sector was grains with a -0.7% decline. Base metals were supported by better than expected data from China (particularly industrial production).

In the energy space, the EIA (US agency) now expects global oil inventories to decline by 200k following recently announced OPEC+ cuts and is expecting an average brent price of $93 in Q4 from a $86 average in August ($94 currently). The EIA also expanded its 2023 oil demand forecast by 50k (to 1.81m bpd) but cut its 2024 forecast by 250k (to 1.36m bpd). Citi Bank is less bullish, flagging that oil priced in the 90's looks unsustainable thanks to non-OPEC+ nations such as Canada, Brazil and Argentina picking up the production slack.

We also had an announcement from the IEA (international agency) predicating peak fossil fuel consumption in 2030. The body has cited insufficient progress on the transition to clean technology and is calling for targeted international collaboration in high emission sectors. Fossil fuel producers warn underinvestment in oil and gas risks further energy crisis if forecasts for peak consumption prove too optimistic.

Fixed Income Asset Allocation Views

18th September 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 continued to tighten, some sectors their richest in over a year. Technicals seem stable; 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 hike before holding to end the year. 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 ▪ 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 have widened in the last couple of weeks, however technical still remain balanced with limited supply over the last couple of months. ▪ Conservatively positioned with fewer idiosyncratic opportunities after market compression, prefer local to hard currency. ▪ Tailwinds: Central bank easing in less inflationary countries, IMF program boost for distressed names. ▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, geopolitical risks, domestic political uncertainty.	▪ China/US relations deteriorate; China property sector challenges not contained ▪ Issuance slows ▪ 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 and EMEA spreads have tightened since last month; with fundamentals showing resilience, minor exceptions in consumer facing names and some energy and utilities. EUR valuations are cheap, prefer USD and Euro to Sterling. ▪ YTD net issuance greater than last year, and expected to pick up in 2H23. Confidence from credit metrics amidst recession uncertainty. Fundamental concerns remain focused on commercial real estate for Banking sector, tight labour supply, weaker consumer, recession concerns.	▪ 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 continue to tightening with valuations inside historic medians. Technicals strong and stable, fundamentals still solid but beginning to show small pockets of weakness. ▪ Prefer conservative position while open to attractive buying opportunities, especially in short HY & BB's and higher quality loans where increased financing costs are less of a headwind. ▪ US HY defaults higher than last year but still at reasonable levels, possibly normalising to historic trends. ▪ Bank loan market continuing May's rally, with overall market dispersion. Themes: 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.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Mortgage index unch or slightly wider than last month with spreads wide of historic medians, the group views agencies as opportunistic. ▪ Supply below expectations from rates but improving with seasonals. Liquidation of failed banks better than feared. ▪ Place to add, prefer high quality and higher coupon assets; constructive view over longer time horizon	▪ Costlier funding and tighter lending standards from bank crisis ▪ Housing activity slows and rising rates move prepays to normal levels without hurting mortgage servicing rates ▪ 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. Delinquency, prepayment, and foreclosure performance remains strong; need labor market weakness to see housing deterioration. ▪ CMBS: We feel cautious, especially on office and multifamily. Credit curve is very steep; non-office sectors remain stable. Delinquencies increasing as maturities come due. ▪ CLOs: Continued modest tightening. Downgrades outpacing upgrades. Prefer new issues, but supply is low. ▪ ABS: Attractive relval in some senior positions; higher quality borrowers remain stable. Market is activewith 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 ▪ 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

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