COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

20 February 2023

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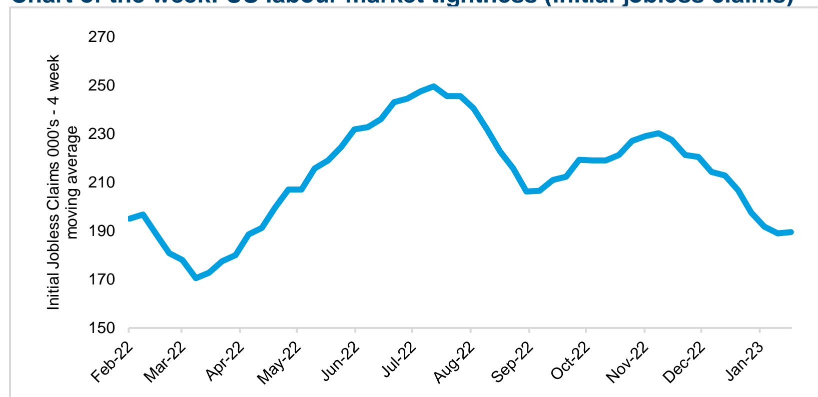
After the goldrush.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	3.81%	8 bps	-1.9%	0.6%
German Bund 10 year	2.46%	10 bps	-1.3%	0.4%
UK Gilt 10 year	3.48%	8 bps	-1.9%	0.8%
Japan 10 year	0.51%	0 bps	1.4%	0.2%
Global Investment Grade	131 bps	2 bps	-1.6%	1.6%
Euro Investment Grade	142 bps	1 bps	-0.4%	1.6%
US Investment Grade	126 bps	3 bps	-2.2%	1.6%
UK Investment Grade	139 bps	2 bps	-0.9%	2.6%
Asia Investment Grade	193 bps	-1 bps	-0.9%	1.5%
Euro High Yield	434 bps	2 bps	0.6%	3.9%
US High Yield	438 bps	14 bps	-1.6%	2.2%
Asia High Yield	613 bps	21 bps	-1.7%	5.3%
EM Sovereign	377 bps	8 bps	-2.1%	0.9%
EM Local	6.8%	13 bps	-2.5%	1.6%
EM Corporate	329 bps	8 bps	-1.1%	1.9%
Bloomberg Barclays US Munis	3.5%	30 bps	-1.9%	1.0%
Taxable Munis	5.0%	7 bps	-2.1%	3.8%
Bloomberg Barclays US MBS	41 bps	-1 bps	-1.8%	1.4%
Bloomberg Commodity Index	233.67	-1.9%	-4.5%	-5.0%
EUR	1.0687	0.2%	-1.5%	-0.1%
JPY	134.08	-2.1%	-3.0%	-2.3%
GBP	1.2035	-0.2%	-2.3%	-0.4%

Source: Bloomberg, Merrill Lynch, as at 17 February 2023.

Chart of the week: US labour market tightness (initial jobless claims)



Source: Bloomberg, Columbia Threadneedle Investments, as at 20 February 2023.

Macro / government bonds

After a strong start to the year in terms of market performance, the last couple of weeks have been heavier going. Bond yields have risen in most places and risk assets have struggled to make further gains. Inflation has not continued to fall as fast as hoped while the economy seems to be performing better and labour market tightness persists **(see chart of the week).** This has caused interest rate expectations to increase once again, after prior hopes of a pause in monetary tightening. The so-called terminal rate of interest in this cycle is currently viewed as being around 5.3% in the US over the next few months.

Last week's focus, data wise, was on inflation. This presented mixed results with US inflation higher than expected, while in the UK a similar measure dropped more than anticipated.

Specifically, US consumer prices (CPI) rose by 6.4% y/y (expected 6.2%) but down from 6.5% in December. Core (ex food and energy) inflation came in at 5.6% (5.5% exp) and versus 5.7% in December. The headline print was boosted by a jump in energy and food prices. Rents rose at the slowest pace in three months and are expected to decline further. US Homebuilders – The NAHB index of homebuilder activity jumped well above consensus. This may be an indication that home sales have bottomed after slumping dramatically in 2022. This has implications for both house prices and the US economy given the substantial contribution of the housing sector. US retail sales jumped 3% in January ahead of 2% expectations. This was driven by an increase in auto and food service sales; housing related sales also rose sharply.

In the UK, CPI dropped to 10.1% y/y (10.3% exp) from 10.5% in December. Core CPI fell to 5.8% y/y (6.2% exp) from 6.3% in December. In further positive news inflation in the services sector slowed an indication that domestically generated inflation may have turned a corner directionally. However, still in the UK, wages rose by more than expected in Q4, to 6.7% y/y. Additionally, 74,000 jobs were added in the economy as businesses fill vacancies left by lower labour force participation due to long term sickness (NHS waiting times), early retirement and a recent surge in student numbers.

Investment grade credit

Investment Grade (IG) credit markets have also paused for breath, after a strong end to last year and robust start to 2023. The combination of rising government bond yields and a slight widening in credit spreads has (modestly) dented year-to-date market returns.

IG markets have been supported by substantial client inflows this year. Data from fund flow tracker EPFR suggests that around $19bn has moved into funds so far this year. The combination of higher government yields and the wider spreads seen last year has presented investors with a more compelling income proposition in a relatively low risk asset class. The global index offers a yield of around 5% presently, which is up from 1.3% at the end of 2020 and higher than the long run average of around 4% according to data from ICE indices. Demand begets supply and last week was no exception with over $50bn of primary issuance. This included a jumbo deal from pharmaceuticals giant Amgen who issued $24bn of new debt to fund the buyout of Horizon Therapeutics.

Meanwhile we are over 50% of the way through the earnings season but have another busy week ahead with HSBC, Telefonica, Munich Re and AXA reporting this week, in addition to several large US retailers such as Walmart and Home Depot.

High yield credit & leveraged loans

US high yield bond prices came under pressure over the past week as strong data and hawkish US Federal Reserve rhetoric led to a reassessment of the Fed's terminal rate. In response, 2-year US treasury yields rose 40bps and the 2s/10s curve reached its most inverted level since the early 1980s. The ICE BofA US HY CP Constrained Index returned -1.84% and spreads were 30bps wider. Borrowers took advantage of an open window for issuance with volume reaching $8.53bn, the largest amount for a single week since November 2021. According to Lipper, the asset class reported an $871m inflow. On the other hand, the average price of the J.P. Morgan Leveraged Loan Index continued to rise over the week, increasing $0.30 to $94.68. The asset class reported a $256m outflow.

European High Yield (EHY) had a second week of negative returns. This was again dominated by macro moves, which pushed underlying government yields higher as spread widening was marginal (+2bps to 434bps) while the index yield rose 0.16% to 7.21%. CCCs outperformed higher rated credits though only single Bs experienced spread tightening relative to the other high yield rating bands. Sterling high yield again outperformed EHY. The latter was hit by ECB wording confirming more hikes are still needed compared to the BoE's more dovish tone for a slowdown in the rate hike pace. Flows into the asset class remain steady, benefiting both ETFs and managed accounts though with a greater emphasis for short duration accounts. The corporate primary market was quiet this week with focus more on the upcoming deal pipeline. Trading was balanced over the week with some risk trimming but also supported by buying on market weakness.

Reports of strong corporate results continued in the auto sector (eg, Renault, Faurecia), retail sector (eg, Douglas) as well as in basic industry sector (eg, Verallia, Rexel). Financial figures are showing revenue improvement accompanied by in line or higher than expected EBITDA. Firms have been able to pass through inflation increases as well as maintain margins. In some cases, margins have risen as pricing has been maintained even as some input costs (such as energy) have come down.

In stock specific news, there are several IPO stories coming to the market. Lottomatica, the Italian gaming firm, may see its IPO come as early as April. The BMC Software story is that the company has filed for an IPO with a valuation of $14-15bn that could come later this year. Bonds for both firms rallied on the news.

Asian credit

The CBIRC (China Banking and Insurance Regulatory Commission) and the PBOC have released a new capital plan with differentiated regulation for banks, which depend on their sizes and risk exposure. The new capital rules will lead to a modest decrease in the risk weighting for loans to higher quality investment grade corporates and general local government bonds. On the other hand, the risk weighting will be increased for lower quality real estate loans and certain off-balance sheet guarantees. Overall, the new capital rules will incentivize banks to

provide loans to higher quality companies and consumer loans but lower the provision of real estate loans and off-balance sheet credit.

Adani Group is reportedly in talks with International Holding Company (IHC, Abu-Dhabi investment company) for a capital infusion of around $1bn to $1.5bn (source: Bloomberg, 14 Feb 2023). The Adani family has also indicated governance changes that could see the appointment of a financial controller to oversee the family's trusts and other privately held companies. Adani Group also indicated that all share-pledged loans will be prepaid in 20 days.

For Adani Green, management indicated it will have an underwriting commitment for a funding facility by end Q1, 2024 to pay the ADANIG Sep '24s ($750m) bond at its legal maturity. The company, however, ruled out a potential bond buyback for ADANIG '24s due to RBI regulations. For the ADGREG Dec '24s ($500m), the company is exploring a potential 15-year private placement instrument.

PTT Global Chemical reported another weak quarter in Q4, 2022, due to refinery maintenance shutdown and weak petrochemicals demand that impacted olefins and polymers. Looking ahead, PTTGC will recalibrate its hedging policy to be more dynamic and it also plans to increase the intake of ethane feedstock, which is less costly than naphtha.

Emerging markets

Rising US treasury yields and wider emerging market spreads resulted in a negative return of -0.82% for the EM hard currency sovereign index over the week (as measured by the JPM EMBI Global). Treasury sensitive names such as the higher quality ones in the Middle East showed signs of weakness, along with Latin American countries due to increased political noise in Ecuador and Peru.

It was announced that Indonesia's current account hit a record surplus of $13.2bn last year (equivalent to 1.3% of GDP) owing to a windfall from its exports of coal and palm oil.

Ratings agencies were active last week. Fitch downgraded Pakistan to CCC- as the situation there gets more desperate with less than two weeks' worth of FX reserves. In more positive news Mongolia was affirmed at B3 by Moody's (outlook stable), as was Poland at A-, by S&P.

In China, the three- and one-year prime loan rates were held once again at 3.65% and 4.30% respectively. The lack of further stimulus makes sense in the context of the recent surge in corporate lending (loan growth up 23% YoY) and the recovery in China's service sector (the Jan services PMI printed at 52.9).

In Turkey, the stock market re-opened rallying by almost 10% following president Erdogan establishing a rule that requires public pension funds to hold more Turkish equities alongside tax waivers on share buybacks.

Commodities

The BCOM index sold off by 1.9% on the week with energy market selling off heavily. Commodity markets were adversely impacted by hawkish US Federal Reserve comments resulting in concern for the future demand outlook and a stronger US dollar, making dollar priced commodities more expensive.

WTI declined by 4.2% on the week following the US Energy Information Administration (EIA) reporting a crude inventory increases of over 16m barrels, which takes supply to the highest levels since June 2021. The supply outlook has also been boosted by Russia announcing they expect to maintain their current level of crude exports despite sanctions.

There is positive news for the market such as the impending return of Chinese crude demand, that the EIA expect will increase demand by 700k barrels a day. Elsewhere the Saudi energy minister stated that the previously agreed 2m barrel OPEC+ production cut will be maintained to the end of the year.

Fixed Income Asset Allocation Views

20th February 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 are less attractive relative to December, technicals and fundamentals stable to improving. **The group remained negative on credit risk, upgrading Investment Grade to neutral and downgrading Structured Products to neutral.** ▪ The Fed Funds market is pricing in a peak of 5% and rates being cut to 4.5% in 2023 ▪ 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. ▪ Uncertainty remains elevated due to fears surrounding recession probabilities, 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, 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 to 2023.
Duration (10-year) ('P' = Periphery)	¥ P $ Short -2 -1 -1 +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)	¥ A$ EM Short -2 -1 0 +1 +2 Long $ €£	▪ Rising expectations around a soft landing and peak Central Bank rates have weakened the dollar ▪ China reopening has amplified this by boosting growth expectations helping risk markets ▪ A material weakening of the dollar from here will need to see growth expectations move significantly higher	▪ 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	▪ 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 unchanged since last meeting, following strong Q4 spread compression and performance. ▪ 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 improving with higher new year issuance	▪ 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 remain stable and technicals remain soft. ▪ Fundamentals remain stable, with strong starting point – expected deterioration may be a 2023 story. ▪ Inflation, labor supply, low dispersion and monetary tightening continue to pressure margins and operating environment. All eyes on Q4 results and '23 outlooks.	▪ Supply remains low. ▪ 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 moved tighter. Prefer conservative position while open to attractive buying opportunities. ▪ Technicals have started to improve with positive fund flows and no defaults in December; more rising stars than fallen angels in 2022. Fundamentals still stable. ▪ Expect 2023 performance will be driven by credit selection amidst fundamental dispersion and distress. ▪ Bank loan market has tightened: market is in equilibrium with fund outflows offset by stable CLO formation and lower new supply.. Concerns about recession and interest cost remain headwinds.	▪ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks ▪ Loan technicals & flows weaken ▪ Global consumer health weakens ▪ Russian invasion & spillover ▪ Commodity prices retrace
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Mortgage index has tightened along with other risk assets. Despite outperformance, valuations still attractive from historic perspective and volatility remain elevated. ▪ Headwinds as money manager demand is small relative to Fed, bank, REIT and overseas selling pressure ▪ Place to add as preference shifts to high quality assets and sentiment is constructive 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 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 still cheap to historical averages but tightening. ▪ CMBS: Mostly solid fundamentals but weakening. Spreads attractive for historical CMBS, but better relval elsewhere. ▪ CLOs: Spreads tighter since December. Default rate increasing and slow new issue supply to start the year ▪ 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 ▪ 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	▪ Global Recession

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