Information for investment professionals

In Credit

20 March 2023

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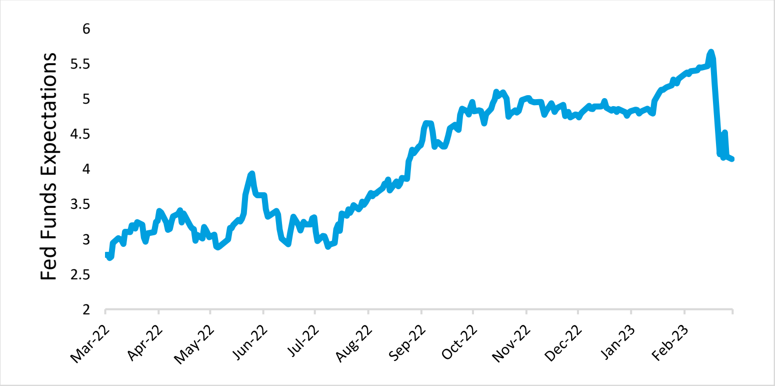
Swiss time ran out.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	3.44%	-26 bps	3.2%	3.3%
German Bund 10 year	2.09%	-42 bps	4.0%	3.1%
UK Gilt 10 year	3.26%	-38 bps	4.8%	4.0%
Japan 10 year	0.25%	-16 bps	1.2%	2.1%
Global Investment Grade	169 bps	27 bps	1.4%	2.3%
Euro Investment Grade	187 bps	36 bps	0.9%	1.5%
US Investment Grade	162 bps	25 bps	1.6%	2.5%
UK Investment Grade	167 bps	19 bps	1.7%	3.1%
Asia Investment Grade	222 bps	10 bps	1.2%	2.3%
Euro High Yield	540 bps	79 bps	-1.1%	2.0%
US High Yield	517 bps	56 bps	-1.0%	1.5%
Asia High Yield	731 bps	86 bps	-0.9%	4.1%
EM Sovereign	421 bps	26 bps	0.3%	1.2%
EM Local	6.6%	-7 bps	0.8%	1.8%
EM Corporate	381 bps	34 bps	0.4%	1.8%
Bloomberg Barclays US Munis	3.4%	-16 bps	1.5%	2.1%
Taxable Munis	4.7%	-12 bps	2.1%	5.3%
Bloomberg Barclays US MBS	56 bps	-4 bps	2.3%	2.9%
Bloomberg Commodity Index	225.27	-1.8%	-3.1%	-8.1%
EUR	1.0715	0.3%	0.9%	-0.3%
JPY	131.66	2.4%	3.3%	-0.6%
GBP	1.2247	1.2%	1.3%	0.7%

Source: Bloomberg, Merrill Lynch, as of 17 March 2023.

Chart of the week: US Sept 2023 interest rate expectations – LTM



Source: Bloomberg, Columbia Threadneedle Investments, as of 20 March 2023.

Macro / government bonds

Government bonds had an amazing week.

This included the largest single decline in the two-year US treasury since the early 1980s. By the start of this week the benchmark 10-year US treasury note was yielding around 3.3%. You will recall that this yield was over 4% earlier this year.

After the collapse of SVB and Signature banks in the US and support provided for other regional banks, the rescue of Swiss bank Credit Suisse last weekend prompted a significant reduction in US (and elsewhere) interest rate expectations. By September of this year, rates are now anticipated to be around 4% **(see chart of the week).** That expectation was closer to 5.5% only a few weeks ago. The fear is one of financial instability and a tightening of financial conditions. These banking failures are being seen as collateral damage in what has been a very aggressive monetary policy tightening cycle. But once again, government bond markets are fulfilling their role in portfolio construction and offsetting the damage being seen in equity and credit markets. This is in stark contrast to last year.

What hasn't changed is that inflation remains above levels at which central banks would feel comfortable. For these institutions there is a tug of war between present financial market volatility and perceived banking sector fragility and their role as targeting lower inflation. The future direction of government bond markets will be determined by which has the greater force. This week brings central bank rates decisions in the US and UK where it feels like there is an even chance of a 25bps rise and no move at all. Not such conservatism from Europe, however. The ECB tightened rates by 0.5% last week – though it appears to have moved to a wait and see (data dependent) stance from here on out.

Investment grade credit

It has been another tough week for investment grade and other credit markets.

Spreads have gaped wider in all areas. The global index, which was trading as tight as 127bps over government bond back in early February, is now close to 170bps. The failure of the two US regional banks the prior week and renewed focus on Swiss lender Credit Suisse means that is has been the banking sector that has led the market wider in spread terms. At the weekend Credit Suisse was bought by rival UBS for around $3bn. This was greeted favourably by Credit Suisse senior debt, which rallied strongly. The banks super subordinated bonds (AT1), however, were all written off to capitalise the new institution, which has left markets with a fair degree of uncertainty. Globally the bank index spread is around 25% wider YTD and the AT1 index over 35% wider. Meanwhile, relative safety has been in seen in utilities – around 7% wider and real estate – which is unchanged in 2023.

In our view, the banking sector entered this present hiccup with record levels of capital and strong earnings built upon rising margins (as interest rates rose). We know that this reflects, in part, the focus of regulation post Global Financial Crisis (GFC) as banks were forced to raise capital to protect against loan losses. The GFC was, after all, an asset quality and capital issue. That regulation did, however, not focus as acutely on liquidity. This present problem is one of high depositor concentration (eg, to an entity or a sector) and interest rate risk. This renders those institutions more dependent on such deposits as likely to be under heavier market scrutiny and others with, for example, higher retail deposits in a ‘more advantageous’ position. It also means that some banks will have to pay more to attract deposits from ‘safer’ competitors and money market funds. This risks a tightening in lending standards and financial conditions.

So, amid the bad news has credit market value returned? All markets now offer spreads that are wide of both five and 20-year averages. In the case of the euro market, now over 1.5 standard deviations wide over that shorter-term average.

High yield credit & leveraged loans

US high yield bond spreads widened by the most since July 2022 and the second most since the pandemic over the past week amid escalating turmoil in the US regional and European banking sectors. The ICE BofA US HY Cash Pay Constrained Index returned -0.41% and spreads were 56bps wider. For context, the past week included the sharpest decline in 2-year US treasury yields since 1987 and the sharpest steepening of the yield curve since the early 1980s as investors rapidly recalibrated Fed expectations. According to Lipper, the asset class reported a $1.4bn outflow for the week, the sixth $1bn+ outflow over the last eight weeks, leaving YTD outflows at $13bn. US leveraged loan (referencing the J.P. Morgan Leveraged Loan Index) prices and yields decreased $1.22 and 16bps over the past week to $93.35 and 9.56%, respectively, amid decompression, the largest weekly retail withdrawals of 2023, and a collapse in the forward curve in response to a rapid recalibration of growth and Fed policy expectations. Retail loan funds saw a $1.6bn withdrawal. The was the largest outflow for the asset class since September and leaves YTD outflows at $7bn.

European High Yield (EHY) sold off with other risk assets last week, returning -0.93% in euro hedged terms. The negative performance was due to spread widening (+79bps to 540bps) as EHY index yield only rose 31bps to almost 8% given the fall in government bond yields. Market expectations rose of a slower pace in rate hikes given the market turmoil on the back of the Credit Suisse story and bank sector implications. The pace of decompression increased with CCCs underperforming BBs by 2.5X. Given the recent banking sector stories in the US and Europe, concern about the banking sector’s ability to fund weaker credits is seen to be adding pressure on higher betas. Sterling high yield once again outperformed EHY. Market flows reverted to net outflows, but this was concentrated in ETFs as managed accounts still experienced inflows. The corporate primary market was quiet last week in the wake of the market turmoil.

On the credit rating front, there were upgrades from Moody’s for aluminium products producer, Constellium (to B1) and gaming firm, IGT (to Ba1), while Fitch upgraded French TV productions, Banijay (to B+). On the credit negative news side, Klockner Pentaplast (plastic packaging manufacturer) was downgraded to B- on weaker results; Grifols down to B2 on weak credit metrics; while Sani ikos (Greek resorts company) saw its rating deteriorate further to Caa2 due to a high net leverage picture, which is not expected to change.

Asian credit

The PBOC cut the RRR (reserve requirement ratio) by 25bps for banks with an RRR above 5%. While a surprise, this is a modest cut that could release slightly above CNY500bn in loanable funds by some estimates. According to the PBOC, the RRR reduction is to ensure reasonable and sufficient liquidity in the system. Altogether, this reflects the policy direction to stabilize growth and support domestic demand

Based on the latest data from Taiwan's Ministry of Finance, the export of semiconductor chips from Taiwan declined by 17.3% y/y. Given the US / China geopolitical tension, the magnitude of export decline to China / HK was much larger at 31.3% y/y n Feb 2023 (vs 27% y/y drop in January). This is the fourth month of export decline to China / HK. Clearly, export restrictions are biting, noting that in January the US secured an agreement with Netherlands and Japan to restrict export of advanced semiconductor tools to China.

Emerging markets

A volatile week in global markets resulted in EM hard currency sovereign bonds returning 0.25% thanks to the rally in US treasuries. The positive return for the EM asset class was despite 26bps of spread widening. Unsurprisingly with the risk off move, the higher quality investment grade sub sector outperformed high yield with African names feeling a lot of the pressure, while Asian and Middle Eastern names fared better.

In ratings news, S&P upgraded Saudi Arabia one notch to A – this was based on structural improvements to its economy and fiscal and debt management.

In Turkey, we received news that President Erdogan's AK party is looking to pivot back towards more conventional economic policies, such as raising interest rates to combat inflation. Erdogan is allegedly looking to appoint Mehmet Şimşek, a man highly respected by the market, as head of the economy. The pivot follows the AK party polling 10 points below the main opposition, inflation hitting 85%, and the Turkish lira losing 60% of its value since early 2021.

In China, we had a series of data releases. Retail sales rose 3.5% in January and February, thanks to improving mobility. Elsewhere industrial production rose 2.4%, while fixed asset investment once again grew strongly at 5.5%. Within the print, real estate investment fell by less than expected at -5.7%, and infrastructure investment surged by 9%. The news points to a steady momentum for China's recovery.

We also had several CPI inflation prints last week with Poland printing at 18.4% YoY (18.5% expectations). The Polish print is indicative of a global theme: disinflation being more gradual than the market would hope. The print was also pushed higher by the reversal of energy price support, something other nations will have to grapple with down the line.

Commodities

Commodity markets faced losses on the week with energy, principally crude (-12.8%), shouldering the brunt of the decline. The market has been hurt by the narrative of slower credit growth, resulting in a slowdown in industrial activity following recent turbulence in the banking sector. Precious metals greatly benefitted from the risk off trade, as gold and silver rallied by 5.6% and 9.5% respectively.

In positive news, Russia and Ukraine agreed to extend the Black Sea grain (and fertilizer) export agreement. Ukraine announced the agreement was extended for 120 days with Russia announcing the agreement was only extended for 60 days.

In the Middle East, Iran has agreed to stop arming the Houthi militant group in Yemen as part of the deal to resume diplomatic relations with Saudi Arabia. The Houthi had previously targeted Saudi oil facilities.

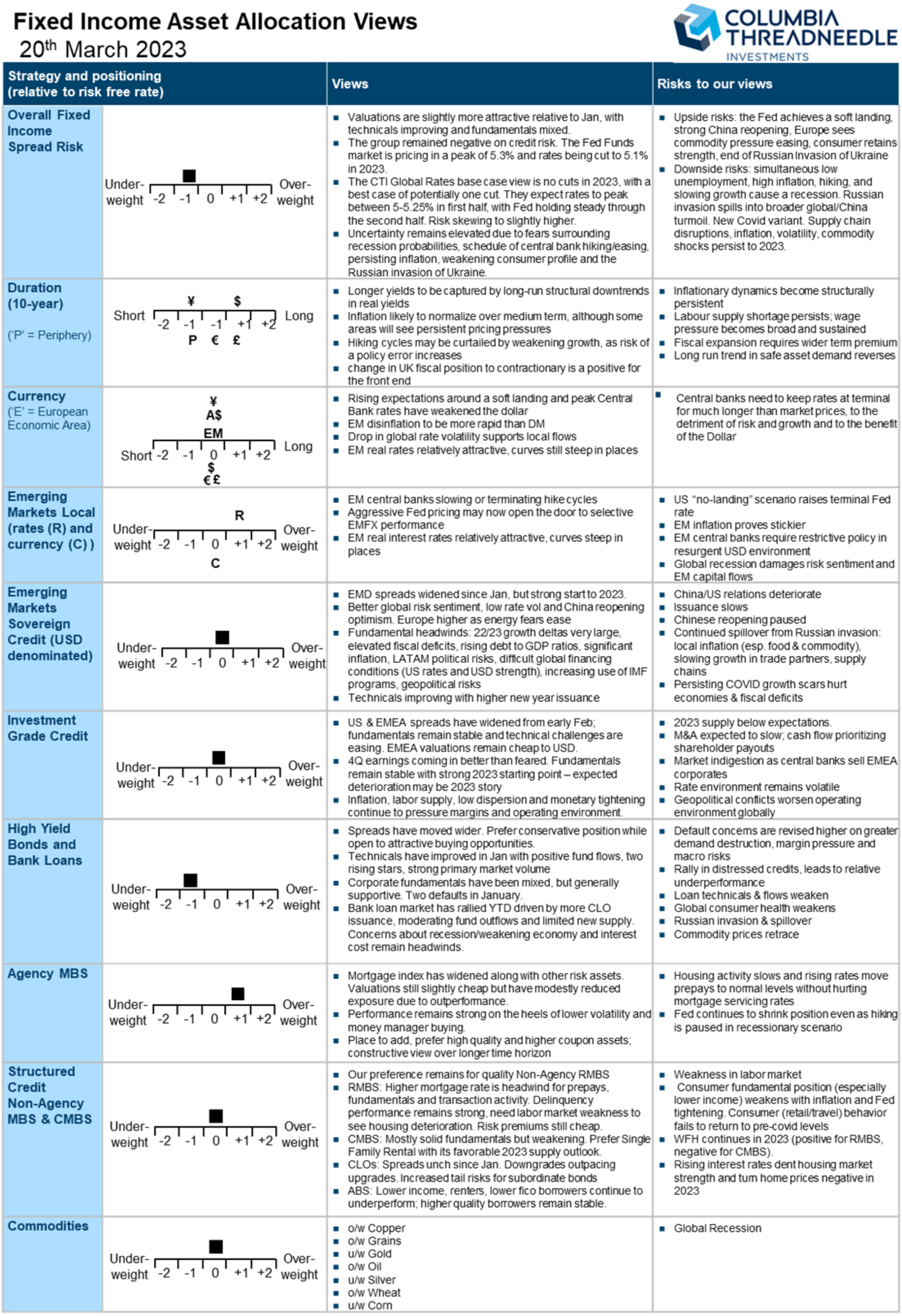
For China, we received commodity import data for January and February. For base metals we saw rising iron ore imports alongside steel output rising by 5.6% y/y. Crude imports were disappointing, falling by 1.25%. For LNG, imports are on track for a 13% y/y increase by the end of March.

Responsible investments

Last week, on the day where over half a million British workers went on strike, UK chancellor Jeremy Hunt presented his first budget address since taking office. Among the various announcements were a few relating to the proposed spending on carbon capture and storage, energy bills and nuclear energy. A massive £20bn has been promised for Carbon Capture and Storage (CCS*) projects, spending up to £1bn per year. However, none of that money has been reflected in the policy costings and none of the money is due to be spent before the next election in 2024. As conflicting as that news was, we await a more detailed announcement later this month when the UK government will be explaining how it will ensure energy security and an update us on how it will reach net-zero by 2050. A slight positive takeaway from the budget is that the term ‘net-zero’ was mentioned 26 times, in contrast to it only being mentioned once in the spring budget earlier this year. Let’s hope there are better positives in the announcement later this month.

Elsewhere, a utility company in Greece formally announced it had failed to meet a carbon emission KPI on its Sustainability-linked bond, resulting in investors receiving 50bps more in interest. The bond was €775m and failed to reduce its scope 1 carbon emissions by 40% relative to 2019, only reducing by 36% to the end of 2022.

*Carbon Capture and Storage is a process in which carbon emitted by various activities, including power generation and industrial activity, is captured securely, transported securely and then stored underground by being injected into rock formations permanently.



Fixed Income Asset Allocation Views

20th March 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 slightly more attractive relative to Jan, with technicals improving and fundamentals mixed. ■ The group remained negative on credit risk. The Fed Funds market is pricing in a peak of 5.3% and rates being cut to 5.1% 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. Risk skewing to slightly higher. ■ 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)	¥ $ Short -2 -1 -1 +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 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 ■ 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 ■ Aggressive Fed pricing may now open the door to selective EMFX performance ■ EM real interest rates relatively attractive, curves steep in places	■ US "no-landing" scenario raises terminal Fed rate ■ EM inflation proves stickier ■ EM central banks require restrictive policy in resurgent USD environment ■ Global recession damages risk sentiment and EM capital flows
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 ■0 +1 +2 Over-weight	■ EMD spreads widened since Jan, but strong start to 2023. ■ Better global risk sentiment, low rate vol and China reopening optimism. Europe higher as energy fears ease ■ 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 ■ Technicals improving with higher new year issuance	■ China/US relations deteriorate ■ Issuance slows ■ Chinese reopening paused ■ 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 widened from early Feb; fundamentals remain stable and technical challenges are easing. EMEA valuations remain cheap to USD. ■ 4Q earnings coming in better than feared. Fundamentals remain stable with strong 2023 starting point – expected deterioration may be 2023 story ■ Inflation, labor supply, low dispersion and monetary tightening continue to pressure margins and operating environment.	■ 2023 supply below expectations. ■ M&A expected to slow; cash flow prioritizing shareholder payouts ■ 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. Prefer conservative position while open to attractive buying opportunities. ■ Technicals have improved in Jan with positive fund flows, two rising stars, strong primary market volume ■ Corporate fundamentals have been mixed, but generally supportive. Two defaults in January. ■ Bank loan market has rallied YTD driven by more CLO issuance, moderating fund outflows and limited new supply. Concerns about recession/weakening economy and interest cost remain headwinds.	■ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks ■ Rally in distressed credits, leads to relative underperformance ■ 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 widened along with other risk assets. Valuations still slightly cheap but have modestly reduced exposure due to outperformance. ■ Performance remains strong on the heels of lower volatility and money manager buying. ■ 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 unch since Jan. 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) 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 ■ o/w Wheat ■ u/w Corn	■ Global Recession

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