COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

23 January 2023

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Commodities
Emerging Markets

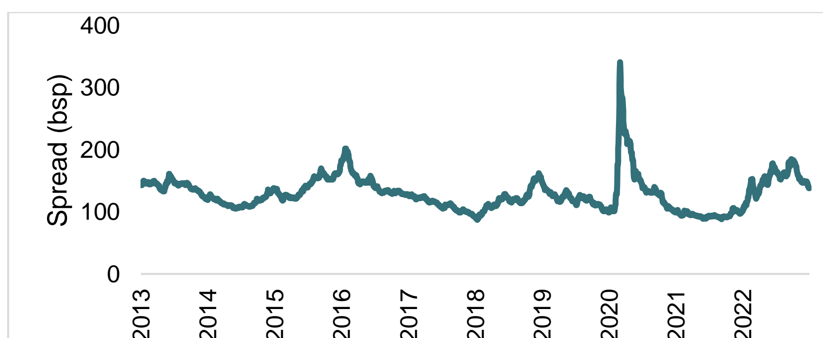
Credit market rally continues.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index YTD return	Index 1 year return
US Treasury 10 year	3.53%	3 bps	2.4%	-9.0%
German Bund 10 year	2.21%	4 bps	2.4%	-14.6%
UK Gilt 10 year	3.38%	1 bps	2.8%	-19.8%
Japan 10 year	0.39%	-12 bps	1.4%	-4.4%
Global Investment Grade	138 bps	-3 bps	3.0%	-10.3%
Euro Investment Grade	153 bps	-6 bps	2.2%	-10.9%
US Investment Grade	129 bps	-3 bps	3.4%	-9.8%
UK Investment Grade	147 bps	0 bps	3.1%	-12.7%
Asia Investment Grade	208 bps	-2 bps	2.6%	-5.7%
Euro High Yield	468 bps	-7 bps	2.9%	-8.7%
US High Yield	435 bps	14 bps	3.6%	-5.4%
Asia High Yield	633 bps	-28 bps	6.8%	-4.3%
EM Sovereign	370 bps	-10 bps	3.4%	-11.1%
EM Local	6.6%	5 bps	4.0%	-8.2%
EM Corporate	339 bps	-9 bps	2.8%	-8.3%
Bloomberg Barclays US Munis	3.1%	-9 bps	2.8%	-3.3%
Taxable Munis	4.8%	-3 bps	5.2%	-13.8%
Bloomberg Barclays US MBS	39 bps	0 bps	3.3%	-7.6%
Bloomberg Commodity Index	244.78	0.6%	-0.3%	6.4%
EUR	1.0847	0.2%	1.4%	-3.4%
JPY	130.86	-1.3%	1.2%	-11.2%
GBP	1.2332	1.4%	2.6%	-7.8%

Source: Bloomberg, Merrill Lynch, as at 20 January 2023.

Chart of the week: Global investment grade spread (bps), 2013-2023



Source: Bloomberg, Columbia Threadneedle Investments, as at 23 January 2023.

Macro / government bonds

Government bond markets have rallied strongly this year but paused for breath last week.

10-year yields have fallen by over 40bps this year, which has helped other markets to follow suit. Mortgage rates have fallen further than this and the yield on US dollar investment grade credit has fallen in yield to around 5% from around 5.5%. This loosening in financial conditions might be a concern for a central bank that is trying to tighten policy.

In terms of last week's highlights, after the prior week's supportive US consumer price inflation data there was more good news. The US producer price index came in at 6.2% y/y in December (expectations were for 6.8% y/y), down from 7.4% in November. This is the lowest level since May 2021. US retail sales were also below market expectations at -1.1% m/m and were down from -0.6% in the previous month. At the headline level, gas station and auto sales dragged down this figure. Elsewhere at the core level, food services (eating out) also contributed to the decline.

UK inflation (CPI) also fell to 10.5% y/y (in line with expectations) from 10.7% in December, offering increasing evidence inflation has peaked. There were still increases for coach and air fares alongside overnight accommodation. Food costs continue to rise with core inflation remaining flat at 6.3%.

In addition to a week of good inflation news, in Europe the combination of lower energy prices, government support and a reopened Chinese economy have combined to force experts to reconsider the prospect of recession. Consensus Economics now expects the eurozone to expand very modestly after polling economists.

In Japan, rates were left unchanged and there was no alteration to yield curve control. There had been increasing expectations that the 10-year control band would rise to 75bps or be dropped altogether. This follows the 10-year yield cap being raised to 50bps in December. Japanese government bonds rallied, and the yen sold off.

Investment grade credit

Investment grade spreads continue to tighten in what has been a strong year – thus far. The combination of tighter spreads **(see chart of the week)** and the lower bond yields discussed above mean that the global index has returned around 6% in local currency terms since the end of the third quarter last year according to data from ICE BofA.

The global index ended last week with a spread of 138bps. That is around 7% tighter since the end of 2022. Specifically sterling markets are the strongest (-11%), with euro (-8%) outperforming the US dollar market (-7%), albeit by a slim margin. Short-dated credit is also leading markets tighter, after its underperformance last year. Globally by rating, BBBs have outperformed while by industry sector media and real estate have outperformed whereas the utility and energy sectors have rallied, but less than the overall market.

After a glut of issuance in the first three weeks of 2023 we expect a slowing in primary activity in the coming five days. In terms of results, Goldman Sachs missed expectations on higher costs while Netflix exceeded on higher new subscriptions.

High yield credit & leveraged loans

US high yield bonds consolidated recent gains over the week as investors absorbed weak global economic data, mixed earnings and ongoing hawkish central bank rhetoric. The ICE BofA US HY CP Constrained Index returned -0.32% and spreads were 13bps wider. The new issue calendar remained active with another $6.7bn issued over the week. According to Lipper, the asset class saw a modest $230m inflow. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index rose $0.22 over the week as the asset class saw its first retail fund inflow in 22 weeks with a modest $35m contribution.

European high yield had another week of positive returns, though the pace softened resulting in only +0.31%. Performance came largely from spread tightening 7bps to 468bps as government yields were largely unchanged for the week. It was also a period of spread compression as CCCs strongly outperformed BBs and Bs. Fund flows had another positive week, this time dominated by managed funds since ETFs saw a marginal amount exiting the asset class. It was a bumper time for the primary market, the likes not seen since early last year, with seven issuers (eg, Tereos, Telecom Italia, Faurecia) coming with eight new deals totalling €3.26bn, mostly BB rated. Many came with a good-sized new issue premium (eg, Faurecia with +70bps premium to its curve) and were well received by the market. As mentioned last week, the new deals are weighted largely towards refinancing activity.

Fourth quarter reporting has not started yet, but the news is looking generally good with demand coming in better than expected (eg, shipping, building materials and retail).

In M&A news, rumours abound of a potential IPO for Lottomatica, the Italian gaming company, by Apollo, the private equity group. In the UK, owners of Asda and EG are looking at merging EG's UK operations as one of the refinancing solutions for EG.

In auto sector news, ZF announced that with Wolfspeed Inc. it plans to build a $3bn wafer factory in the Saarland region for production of chips for electric vehicles and other applications. This comes at the same time as Ford's restructuring news regarding its Cologne plant, which may mean layoffs of around 8,000 across the business.

Structured credit

The US Agency MBS market eked out a positive return last week gaining 23bps. As the yield curve further inverted, 30-year mortgages outperformed 15s. Spreads were marginally wider but not enough to offset the rally and their carry; 30-year spreads remain relatively cheap, while 15-year spreads are now on the rich side. The consensus view is for January prepayment speeds to fall c25%, primarily on seasonals. In non-agency MBS, new issuance picked back up with $3bn priced YTD. Spreads across non-agency RMBS have been mostly unchanged YTD and non-QM AAA remain cheap versus IG. The CMBS market was quiet in the primary market while secondary trading was more active. CMBS spreads were mostly tighter week-over-week, as current levels remain attractive versus ABS and Corps. There has been heavier supply in ABS, which has been well bid keeping spreads relatively stable. Issuer remittance reports are indicating an increase in delinquencies and defaults across Autos, Cards, Consumer Loans and Student Loans, however, these numbers are coming off historically low levels.

Emerging markets

Emerging market bonds rallied last week, returning +0.87% (JP Morgan EMBI Global Index) as spreads tightened 10bps. High yield returns were aided by the performance of distressed names such as Sri Lanka and Venezuela.

In Brazil, President Lulu fired the Gen Júlio Cesar de Arruda, the head of the army. The decision follows reports that Arruda stopped the police from detaining right-wing protesters during the recent insurrection. Lula has also reportedly ousted at least 80 military officials with the aim of removing Bolsonaro hardliners.

In Ukraine, the EU is expected to approve another €500m of support following a further $2.5bn weapons package from the US. Elsewhere, Poland is seeking permission from Germany to send 14 German made advanced Leopard 2 tanks.

Technicals in the EMD space are currently looking very favourable; primary market YTD issuance has surged to $40.2bn, a January record and over a third of issuance we saw in 2022. Last week we saw Saudi Arabia come to the market with a $10bn deal across three tranches. The slew of supply has been driven by investment grade issuers with long duration paper accounting for a high proportion of the activity as investors' appetite for longer tenure bonds increased. We have also been encouraged by a return of inflows into the asset class; last week flows accelerated to the largest level since June 2021. YTD there has been +$3.8bn into EM bond funds.

Commodities

Commodities rallied modestly on the week (+0.6%) with energy markets and base metals continuing their 2023 rise.

Copper continues to perform and is now up 11.6% for 2023. The outlook for copper was supported by the news than Glencore's Antapaccay mine in Peru was forced to halt operations due to protests and looting. The mine in question accounted for 8% of Peru's copper exports, an estimated 2% of global copper supply is at risk due to the ongoing Peruvian unrest.

In energy markets we are fast approaching the 5 February EU ban on imports of refined petroleum products from Russia following the ban on seaborne crude back in December. The impending ban is concerning for diesel and jet fuel where a loss of Russian supply may result in shortages and upward pressure on prices. Russia was the source of around half of the EU's diesel imports in 2022 and approximately 5% of jet fuel imports. A loss of jet fuel supply could cause problems for European airlines given the strong outlook for bookings this summer.

Fixed Income Asset Allocation Views

23rd January 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 become less attractive since November, technical and fundamentals moving sideways. **The group shifted negative on credit risk, downgrading Investment Grade and upgrading Structured Products and Emerging Markets.** ▪ We are past the peak of economic growth, with expectations for more 25bp hikes in 1H 2023, followed by multiple cuts in 2023. ▪ Uncertainty remains elevated due to fears surrounding recession probabilities, schedule of central bank hiking/easing, inflation, weakening consumer profile and the Russian invasion of Ukraine.	▪ Upside risks: the Fed achieves a soft landing, 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 (¥) 0 (P, €) +1 ($, £) +2 Long	▪ Longer yields to be captured by long-run structural downtrends in real yields ▪ Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures ▪ Hiking cycles may be curtailed by weakening growth, as risk of a policy error increases ▪ change in UK fiscal position to contractionary is a positive for the front end	▪ Inflationary dynamics become structurally persistent ▪ Labour supply shortage persists; wage pressure becomes broad and sustained ▪ Fiscal expansion requires wider term premium ▪ Long run trend in safe asset demand reverses
Currency ('E' = European Economic Area)	Short -2 -1 0 (¥, A$, EM, $, €£) +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))	Under-weight -2 -1 0 (C) +1 (R) +2 Over-weight	▪ 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 tighter since last meeting; strong performance, even with in weaker credit quality names. ▪ 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 (outflows and supply) remain a headwind	▪ 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 and technicals are unchanged. ▪ Fundamentals remain stable, have yet to see expected deterioration – may be a 2023 story. ▪ Inflation, labor supply, low dispersion and monetary tightening continue to pressure margins and operating environment. Waiting for Q4 results and '23 outlooks.	▪ 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 continued widening. Combined with greater downside risks, the group prefers conservative position while open to attractive buying opportunities. ▪ Technicals have started to improve with positive fund flows and no defaults in October. Light primary market ▪ Bank loan market has moved sideways: greater volatility and fund outflows are offset by stable CLO formation and less new loan issuance. Concerns about recession and interest cost remain headwinds. No defaults since September, calendar is opening for higher quality issuers	▪ Default concerns are focused on demand destruction, margin pressure and macro risks ▪ Loan technicals & flows weaken ▪ Global consumer health weakens ▪ Russian invasion & spillover ▪ Commodity prices continue to retrace
Agency MBS	Under-weight -2 -1 0 +1 ■ +2 Over-weight	▪ Mortgage spreads have widened in past month to the cheapest level in a decade; valuations and long-term fundamentals pushed the group to upgrade Agency MBSCurrent coupon spreads near recent wides ▪ Headwinds as money manager demand is small relative to Fed, bank, REIT and overseas selling pressure ▪ Looking to add as preference shifts to high quality assets	▪ 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 are attractive; moving to buy higher quality risk ▪ CMBS: Mostly solid fundamentals but weakening. Spreads attractive for historical CMBS, but better relval elsewhere. ▪ CLOs: Spreads modestly tighter, Mezz spreads firming along with macro. Default rate increasing. ▪ 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 ▪ Work From Home continues fullsteam-ahead post-pandemic (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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