In Credit

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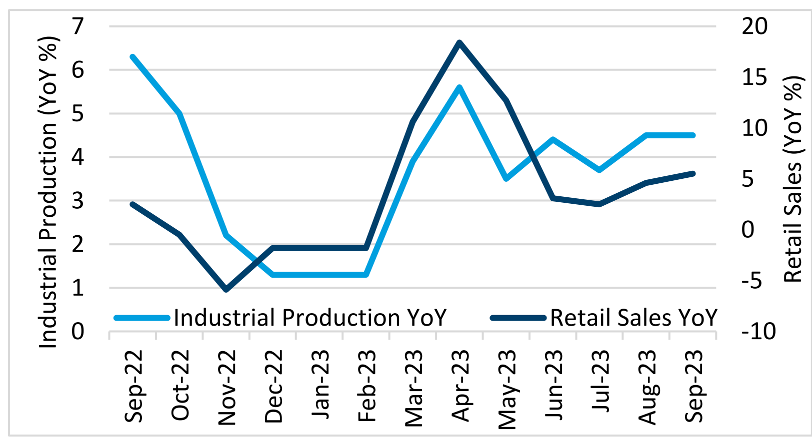
Firmer footing for China

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.98%	37 bps	-1.5%	-3.3%
German Bund 10 year	2.95%	21 bps	-0.3%	-1.5%
UK Gilt 10 year	4.70%	31 bps	-1.8%	-6.3%
Japan 10 year	0.88%	12 bps	-0.9%	-1.4%
Global Investment Grade	142 bps	5 bps	-1.6%	-0.5%
Euro Investment Grade	162 bps	4 bps	-0.4%	1.9%
US Investment Grade	133 bps	6 bps	-2.2%	-1.7%
UK Investment Grade	137 bps	3 bps	-1.1%	0.0%
Asia Investment Grade	201 bps	-5 bps	-1.0%	1.3%
Euro High Yield	510 bps	24 bps	-1.1%	5.1%
US High Yield	452 bps	22 bps	-1.9%	3.9%
Asia High Yield	946 bps	17 bps	-1.2%	-5.8%
EM Sovereign	379 bps	1 bps	-2.4%	-1.3%
EM Local	6.9%	14 bps	-1.5%	2.7%
EM Corporate	345 bps	0 bps	-1.4%	1.9%
Bloomberg Barclays US Munis	4.5%	21 bps	-0.8%	-2.2%
Taxable Munis	5.9%	24 bps	-3.1%	-3.2%
Bloomberg Barclays US MBS	80 bps	9 bps	-2.7%	-4.9%
Bloomberg Commodity Index	239.31	0.6%	1.2%	-2.2%
EUR	1.0606	0.8%	0.2%	-1.0%
JPY	149.94	-0.2%	-0.3%	-12.5%
GBP	1.2173	0.2%	-0.3%	0.7%

Source: Bloomberg, ICE Indices, as of 20 October 2023. *QTD denotes returns from 30 September 2023

Chart of the week: Chinese retail sales and industrial production



Source iCE Indices, Bloomberg and Columbia Threadneedle Investments, as of 20 October 2023.

Macro / government bonds

The big trend to mark fixed income markets this week was further steepening of the yield curve. It was a week in which geo-political concerns temporarily faded as investors turned their attention back to the state of the global economy.

In the US, retail sales and industrial production came in stronger than expected, pushing the yield on the 10-year US Treasury to the cusp of 5% – a level it has subsequently pierced. This brought to the fore the much-repeated question that has plagued markets as we reach terminal rate levels: has the Federal Reserve done enough to control inflation? In a speech to the Economic Club of New York, Fed Chairman, Jay Powell, made a number of observations. First, that the economy had been much more resilient than expected. Second, that they should "proceed carefully" with monetary policy, given the increasingly double-edged nature of the risks they face, ie the risk of overtightening versus undertightening. Third, he mentioned that the recent rise in long-term bond yields had reduced the need for further hikes, at the margin. The market interpreted Powell's comments as code that there would be no interest rate rise at the next meeting at the start of November.

Reflecting this, the Fed Funds Futures market barely moved over the course of the week, pricing in a less than 40% probability of a rate rise by January 2024. Other policymakers at the Fed gave similar messages of patience as they awaited further evidence that the disinflationary process was underway. While the strength of incoming data will continue to frame the debate about the need for further monetary tightening, the market is likely to remain edgy until there is greater confidence that we have reached terminal rate levels.

One trend that continued unabated last week was the bear steepening trend in core fixed income markets, as longer-dated rates continued to rise at a faster pace than shorter-dated rates. This reflected a mix of rising levels of issuance and the prospect of greater fiscal expenditure. International bond markets weakened, partly in response to the gravitational pull exerted by the US Treasury market, and partly to elevated levels of inflation in domestic markets. Illustrating this, headline and core inflation in the UK came in stronger than expected, while in Italy bond yields continued to weaken relative to the core eurozone market of Germany. The primary catalyst for this has been an expected fiscal deterioration in Italy as bond yields in the heavily indebted country continue to rise, all at a time when the European Central Bank has stepped away as a price insensitive buyer of Italian sovereign debt.

Our major positions remain modest long duration positions in core markets, outside of Japan, yield curve steepening positions in core markets, and a cross-market underweight position in Italy.

Investment grade credit

Last week saw a weak performance from investment grade markets. The Global Index spread ended the week at 143bps, which is around five basis points wider on the week. This comes agaisnt a backdrop of universally strong economic data (retail sales, industrial production and jobless claims), which in turn brings fears that the Federal Reserve has more work to do to slow the economy.

The widening in spreads coupled with rising bond yields has brought negative total returns. This experience has unnerved investors and outflows have been recorded, especially in the US Mutual Fund Market. Despite the recent disappointment, global investment grade now offers 5.84%. This follows yields hitting a new cycle high of 5.92% – the highest level since 2009.

The widening in spreads has taken the global index back to the long-term average, so neither rich nor cheap. On a similar comparison the Euro market looks cheapest of the major markets. We have also noted a flattening the USD credit curve with short dated bonds performing especially poorly.

High yield credit & leveraged loans

US high yield bond yields rose to one-year highs amid rapidly rising rates, an escalation of geopolitical tensions in the Middle East, and large outflows. The ICE BofA US HY CP Constrained Index Returned -1.23% and spreads were 22bps wider. According to Lipper, retail high yield bond funds saw a $1.9 billion outflow. This brought trailing four-week outflows to $9.4 billion, the largest four-week outflow in nine years. Floating rate loans continued to outperform their high yield counterparts with the average price of the JP Morgan Leveraged Loan Index moving just $0.05 lower over the week. Retail loans fund outflows were modest at just $26 million.

European HY had a poor week returning -0.9% as spreads widened 24bps to 510bps and yields rose 30bps to 8.43%. It was another decompression week as BBs outperformed with CCCs experiencing wider spreads and loosing 1.7X more than BBs. GBP HY outperformed Euro HY. In spite of the market's poor performance, fund flows were net modestly positive with inflows in ETFs and full market managed accounts versus outflows for short-dated funds. Corporate primary market had another subdued week with just one €140 million tap.

In M&A news, private equity group CVC Capital Partners is said to be considering a bid for European payments giant Nexi. The company has a current market price valuation of €8.3 billion. In rating action news, Peach Properties was downgraded two notches from B1 to B3 by Moody's. The rating agency cited "unsustainable capital structure amidst a challenging funding environment" and refinancing concerns. Better news for TI Fluids, the British automotives part business, as they were upgrade two notches by S&P to BB. There was also good news for Tui Cruises which saw its corporate family rating upgraded to B2 and its unsecured bonds upgraded to Caa1. The agency cited an expectation of a reduction in leverage by the end of the year on the back of strong recovery in occupancy and better than expected cost controls.
In sector news, autos continue to see strong car sales with September showing an 11% rise in sales, the fourteenth consecutive month of increases.

More talk of Fallen Angels for 2024 with expectations of €20 billion and the majority will be in the real estate sector (JP Morgan).

Structured credit

It was a very rough week for the US Agency MBS sector. Returns were -2.23% which would historically be associated with a bad year, not a bad week. Rate volatility continues to swamp this duration-sensitive asset class and keep buyers at bay. In that environment 15-year bonds outperformed 30s. Spreads remain historically wide. Prepayment speeds are expected to slow another 4% as a result. In non-agency, spreads also widened alongside heightened geopolitical risk and a softer tone. Lower quality credit especially felt the pain. CMBS primary market activity picked up last week despite higher volatility. Downgrades continue to be the trend with 48 bonds downgraded versus no upgrades.

Asian credit

Sands China reported a set of strong Q3 results, with its quarterly revenue and EBITDA at 84.8% and 83.6% of the pre-Covid Q3 2019 levels respectively. Its adjusted property EBITDA margin was 35.3% in 3Q23 – a steady improvement through 2023 after the company returned to positive EBITDA. The market-wide mass GGR (gross gaming revenue) in Macau was around $5.1 billion or 92% of the pre-Covid Q3 2019 level.

TSMC's Q3 results continued to be hampered by slow demand recovery and the ongoing inventory digestion in the semiconductor sector that will stretch through Q4 2023. While the company reported strong AI-related demand, the bulk of its business is associated with mobile and mainstream HPC (high performance computing) that is facing weak demand growth.

The Chinese tax and natural resource authorities are reportedly probing Foxconn for tax issues and land use in the Henan and Hubei provinces. Foxconn stated it will actively cooperate with the relevant authorities in the investigation.

Emerging markets

The EM mood remains defensive against rising US Treasury yields and higher oil prices as a result of the tensions in the Middle East. The index returned -1.44% over the week with the US Treasury component driving the negative return. EM spreads were unchanged at 379bps.

In China we had a positive data release, with retail sales and industrial production beating expectations **(see Chart of the week)**. The retail sales print was the most impressive at 5.5% versus expectations of 4.9%, with the release indicative of stabilisation in China following the stalled recovery in Q1. On the GDP front, Q3 GDP printed at 1.3% versus expectations of 0.9%. The market currently expects full-year GDP to be 5% in line with the government target.

Egypt was downgraded one notch to B- by S&P owing to delays in implementing structural reforms which are required in order to secure a disbursement from the IMF. Moody's downgraded Egypt to Caa1 in a surprise move a couple of weeks earlier. Israel has been placed on negative watch by Moody's and Fitch due to the conflict and concerns that an escalation will have a material and prolonged impact on the economy.

Sri Lanka secured a staff-level agreement with the IMF to receive the next disbursement from its $3 billion bailout program.

In Argentina, economy minister Massa took the most votes (37%) in the first-round presidential elections at the expense of right-wing candidate Milei. Hard currency bonds sold off by 2+ points on the news. Argentina is facing 138% inflation alongside poverty at 40%. The one-month wait to the next round creates uncertainty alongside the potential for fiscally expensive measures by Massa who has cut taxes and increased social spending to bolster support. Argentina requires fiscal adjustment as part of its $43 billion IMF programme. Milei favours a reduced role of government, slashing public spending and replacing the peso with the dollar.

Commodities

The BCOM rallied by 0.6% on the week with a safe haven bid in precious metals (+2.6%) being offset by declines in the energy complex.

Oil has gained around 5% since the Hamas attack on Israel earlier this month but has given back some gains on the delayed ground invasion of Gaza. There is also the prospect of additional crude supply from Venezuela as the US eased sanctions on oil exploration by foreign companies. In the US, natural gas prices declined by 8.3% and are now down 54% YTD.

Responsible investments

While it has been fairly quiet in the US for labelled bond issuance, JP Morgan Chase issued a tranche of green bonds last week, totalling $7.5 billion. There were three parts to the issuance with the earliest bond set to mature in four years (callable in three years). In typical green bond fashion, use-of-proceeds will be directed at projects including energy efficient buildings and sustainable transportation. Total green bond sales in the year to-date have now exceeded the high of 2021, according to Bloomberg, shaping the likelihood we will have a record-breaking year in all ESG-labelled bond issuance for 2023.

The cheapest electric vehicle in Europe started taking orders last week as Citroën released its ë-C3 model. Starting at €23,300, the ë-C3 will be manufactured in Slovakia to keep costs low with the first batch due to be rolling off the line during the second quarter of next year. The car will have a range of nearly 200 miles and appears to meet the requirements of the €100-a-month EV leasing plan initiated in France by President Macron.

Fixed Income Asset Allocation Views

23rd October 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 [■ at 0]	▪ Valuations continue to be rich overall but have cheapened in the past month. Technicals seem stable; fundamentals show modest pockets of weakness but no thematic deterioration. **The Group stands neutral on Credit risk overall upgrading High Yield and Structured Credit.** ▪ The CTI Global Rates base case view is no cuts in 2023, with one more possible hike left in the hiking cycle. Focus remains on wages, labor market, financial conditions, and inflation expectations. ▪ Uncertainty remains elevated due to geopolitical tension, stricter lending, monetary policy tightening, persisting inflation, and weakening consumer profile.	▪ Upside risks: the Fed achieves a soft lan with no labour softening; consumer retai strength; end to Ukraine and Israel-Hama wars. ▪ Downside risks: Fed is not done hiking a unemployment rises. Another banking cr this time from unrealised losses on secu and CRE, supply chain disruptions, inflat volatility, commodity shocks re-emerge.
Duration (10-year) ('P' = Periphery)	Short -2 -1 0 +1 +2 Long [¥ at -1, $ at +1; P at -1, € £ at +1]	▪ 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 structurall persistent ▪ Labour supply shortage persists; wage pressure becomes broad and sustained ▪ Fiscal expansion requires wider term pre ▪ Long run trend in safe asset demand rev
Currency ('E' = European Economic Area)	Short -2 -1 0 +1 +2 Long [EM A$ at 0; ¥ € $ £ at 0]	▪ 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.	▪ Central banks need to keep rates at tern for much longer than market prices, to th detriment of risk and growth and to the b of the Dollar
Emerging Markets Local (rates (R) and currency (C))	Under-weight -2 -1 0 +1 +2 Over-weight [R at +1; C at 0]	▪ Disinflation under threat but intact; EM central banks still in easing mode. ▪ Real yields remain high. ▪ Selected curves continue to hold attractive risk premium.	▪ Sustained high core rates thwart EM eas cycles. ▪ Energy persistence derails disinflation tre ▪ US outperformance strengthens US dolla ▪ Structurally higher global real rate enviro subdues risk assets
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight [■ at -1]	▪ EMD spreads 30bps wider than last month, reversing the early summer rally. Technicals are slower, outflow and weak issuance. ▪ Conservatively positioned with most idiosyncratic opportunities in lower quality portion of index, focus on relval opportunities. ▪ Tailwinds: Central bank easing in less inflationary countries, potential China stimulus, IMF program boost for distressed names. ▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, geopolitical and domestic political uncertainty, restructurings slow.	▪ China/US relations deteriorate. ▪ Issuance slows. ▪ Spill over from Russian invasion and Isra Hamas war: 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 [■ at 0]	▪ US and EMEA spreads have widened since last month. Fundamentals are in focus as earnings report. Global portfolios prefer EUR IG over USD on relval basis. ▪ Fundamental concerns remain focused on commercial real estate and unrealised losses for banking sector, tight labor supply, changing consumer behaviour.	▪ Lending standards continue tightening, e after Fed pauses hiking cycle. ▪ Rate environment remains volatile ▪ Mass layoffs spike, worsening consumer profile. ▪ Geopolitical conflicts worsen operating environment globally
High Yield Bonds and Bank Loans	Under-weight -2 -1 0 +1 +2 Over-weight [■ at 0]	▪ The group upgraded HY as prices have fallen, while technical and high-quality HY fundamentals remain stable. Financial conditions continue to punish destressed names. ▪ Conservatively positioned, but open to attractive buying opportunities in short HY, BBs and higher quality loans. ▪ US HY defaults remain below historic averages, with greater default expectations for 2024. ▪ Bank loan market has been more volatile in the past month. Themes: moderating retail fund outflows, delayed defaults, improving CLO issuance, increasing interest burden, credit concern in lower quality loans.	▪ Lending standards continue tightening, increasing the cost of funding. ▪ Default concerns are revised higher on g demand destruction, margin pressure an macro risks ▪ Rally in distressed credits, leads to relati underperformance ▪ Volatility in the short end of the curve, er potential upside where we are positioned carry.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight [■ at +2]	▪ Mortgage index at similar lever to last month with spreads wide of historic medians, the group views agencies as attractive. ▪ Supply is manageable as higher rates and fall seasonals kick in. ▪ Performance has been driven by the Fed's hiking cycle, with MBS widening into a bear steepener. ▪ Place to add, prefer high coupon assets; constructive view over longer time horizon.	▪ Lending standards continue tightening e after Fed pauses hiking cycle. ▪ Prepayments normalise as rates rise with reducing mortgage servicing. ▪ Fed continues to shrink position. ▪ Market volatility erodes value from carryi
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight [■ at +1]	▪ Upgraded outlook because of decent risk-adjusted valuations in select high quality Non-agency RMBS, CLOs and ABS. ▪ RMBS: September saw spreads widen, attractive risk-adjusted valuations. Home prices resilient despite headwinds. Delinquency, prepayment and foreclosure performance remains strong. Expect fundamentals to hold in as long as labor market strength remains. ▪ CMBS: The group is cautious, especially on office and multifamily, however non-office sectors perform as expected. Delinquencies increasing as maturities come due. Credit curve remains steep. ▪ CLOs: Spreads softer in past month. Defaults remain low but CCC buckets continue to rise slowly. ▪ ABS: Attractive relval in some senior positions. Higher quality borrowers remain stable, lower quality borrowers underperform. Student loan repayments restart, with 12 month ramp up period.	▪ Weakness in labour market ▪ Consumer fundamental position (especi lower income) weakens with inflation and tightening. Consumer (retail/travel) beha fails to return to pre-covid levels ▪ Student loan repayments weaken consu profile more than anticipated, affecting sp on a secular level. ▪ Rising interest rates turn home prices negative, denting housing market strengt ▪ Cross sector contagion from CRE weakn
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight [■ at 0]	▪ 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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