COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

25 September 2023

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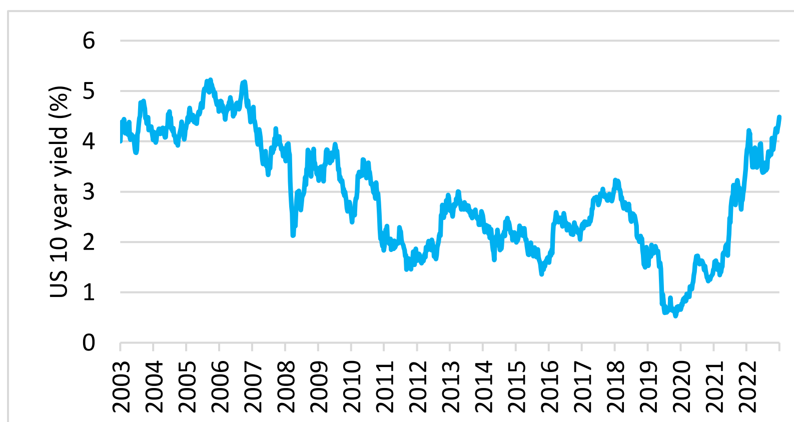
Same result, reaction

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	4.50%	17 bps	-2.6%	-1.0%
German Bund 10 year	2.80%	12 bps	-1.9%	-0.8%
UK Gilt 10 year	4.31%	-5 bps	0.7%	-3.2%
Japan 10 year	0.74%	2 bps	-2.9%	-0.3%
Global Investment Grade	129 bps	-2 bps	-0.9%	1.8%
Euro Investment Grade	146 bps	1 bps	0.5%	2.6%
US Investment Grade	120 bps	-2 bps	-1.7%	1.5%
UK Investment Grade	131 bps	0 bps	3.0%	2.0%
Asia Investment Grade	202 bps	0 bps	-0.7%	2.4%
Euro High Yield	444 bps	7 bps	2.1%	6.6%
US High Yield	393 bps	14 bps	1.0%	6.4%
Asia High Yield	952 bps	9 bps	-4.0%	-4.1%
EM Sovereign	356 bps	6 bps	-1.5%	2.3%
EM Local	6.6%	12 bps	-1.9%	5.7%
EM Corporate	329 bps	0 bps	0.1%	3.8%
Bloomberg Barclays US Munis	4.1%	18 bps	-2.5%	0.2%
Taxable Munis	5.5%	9 bps	-3.6%	1.2%
Bloomberg Barclays US MBS	58 bps	3 bps	-2.7%	-0.9%
Bloomberg Commodity Index	239.77	-1.1%	6.0%	-2.3%
EUR	1.0624	0.0%	-2.3%	-0.5%
JPY	148.72	-0.4%	-2.7%	-11.6%
GBP	1.2218	-1.1%	-3.6%	1.3%

Source: Bloomberg, ICE Indices, as of 22 September 2023.

Chart of the week – US Treasury 10-year yield, 2003-2023



Source Bloomberg and Columbia Threadneedle Investments, as of 25 September 2023.

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Macro / government bonds

There was no change in policy conditions after the FOMC meeting in the US and from the Monetary Policy Committee in the UK last week. The result of these moves in terms of bond market performance was, however, rather different.

The US Federal Reserve left interest rates unchanged at 5.25-5.5%, but updated its 'dot plots' (Fed forecasts) to show an expectation of one more rate hike this year with 50bps of easing pencilled in for next year (this is down from a 100bps decline previously). So this means that the Fed expects to keep interest rates higher for longer.

The Fed also amended some economic forecasts. Unemployment expectations were revised down to a rate of 4.1% (from 4.5% previously) for 2024. Elsewhere, the Fed's core inflation (PCE) forecast for 2023 (the preferred gauge of inflation) has been edged down from 3.9% to 3.7%. In terms of economic growth it expects 2.1% for 2023, 1.5% for 2024 and 1.8% for the year after. There is no expectation of a recession or hard landing – so little need to cut rates swiftly next year. Yields rose on the Fed's actions and perceived intentions reaching the highest level for 10-year yields since before the Global Financial Crisis **(see chart of the week).**

The Bank of England also left rates unchanged at 5.25% in a 5-4 vote split (with the 4 voting for +25bps). The undershoot in the most recent inflation data release appears to have been the deciding factor in leaving rates unchanged.

The BoE noted that it will continue to focus on the tightness in the labour market, wage growth and service price inflation. With surveys pointing to an increase in labour market slack and a slowdown in wages many economists believe that 5.25% is the highest point in this aggressive tightening cycle.The bank also voted for £100bn in gilt sales (Quantitative Tightening) over the next 12 months, a step up from £80bn previously. However, with £50bn of gilts maturing over this timeframe "active" selling by the bank is only ticking up from £45bn to £50bn. Gilt yields moved in the opposite direction to the US and after a period of underperformance.

This week brings US durable goods, consumer confidence and core PCE inflation data. In Europe we get emplyoment and inflation data as well as consumer confidence updates.

Investment Grade credit

Investment grade credit spreads tightened by another couple of basis points last week. The US market outperformed its European cousin in the last five trading days.

Supporting the investment grade market this month has been a somewhat underwhelming primary market pipeline after a robust start to September and high expectations and inflows into the market as investors seek to 'lock in' the present higher yields as we close on the perceived peak in the interest rate cycle in many areas. Yields in all areas have come a significant distance in a relatively short period of time and present an interesting income opportunity to pensioners, savers and investors.

In company specific news, Telecom giant Vodafone announced plans to sell 50% of its Spanish unit.

High yield credit & leveraged loans

US high yield bond valuations widened as a hawkish hold by the Fed was accompanied by the highest 10-year US treasury yield since 2007, a nearly 4% loss on the S&P 500, and an active new issue calendar.

The ICE BofA US HY CP Constrained Index returned -0.64% and spreads were 17bps wider. According to Lipper, retail high yield funds saw a $416m outflow. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index finished a touch lower at $95.79 as investors also absorbed elevated capital market activity and sizeable retail fund inflows. Retail loan funds saw a $539m inflow, the fifth inflow over the last six weeks and largest since May 2022.

Last week saw European High Yield experience its second largest issuance week (c€4.4bn) since the start of 2022. There were six euro deals and one sterling deal of mostly BBs but also two single B issues, all refinancings. The primary market saw good to strong oversubscription, taking the YTD gross issuance to €45.5bn but with net issuance still holding at a modest €1.5bn. In absorbing the new issuance size, the market took a pause in its recent rally, returning -0.16% with spread widening +7bps to 444bps and yield rising +11bps to 7.78%. Single Bs underperformed both BBs and CCCs for once while sterling high yield strongly outperformed EHY (+0.41% vs -0.20%). Outflows slowed to a crawl with only -€37m exiting, due to ETFs as managed accounts saw net inflows for the week.

In sector news, the auto sector is showing a twist as auto parts manufacturers are underperforming more than the auto manufacturers themselves. The whole sector saw some pressure last week, on the back of the auto workers' strike in the US. In the gaming space, Entain (owner of Ladbrokes) announced a slowdown in online gaming, bringing down its expectation to online gaming revenue for Q3. This is the first slowdown being seen in the gaming sector.

In credit rating news, INTRUM, UK debt collectors, was downgraded two notches to B2 by Moody's citing limited progress in deleveraging.

Securitised credit

The US Agency MBS market suffered alongside duration sensitive asset classes on higher interest rates stemming from a slightly more hawkish Fed. The sector was down 71bps on the week and spreads widened another 5-6bps with lower coupon mortgages bearing the brunt. 15-year agency MBS outperformed 30s, and higher coupons did best. At this point, September prepayment speeds are projected to fall considerably, weighed on by both rates and a lower day count for the month. In Non-agency, residential new issuance was higher last week as was secondary trading. Spreads tightened again in CRTs while they widened in non-qualifying mortgages.

In CMBS, higher rates kept issuance more subdued, and spreads were relatively flat w/w. Strength in spreads at the top of the capital stack seems to indicate investor interest and comfort in tactically adding given credit enhancement at those higher tiers. In terms of rating changes, 121 bonds were downgraded (40 deals), which is the highest amount in recent history on Fitch's ongoing review. In comparison, only nine deals were upgraded.

Asian credit

TotalEnergies is reportedly close to investing around $300m in a new JV with Adani Green Energy (Bloomberg). This 50/50 JV will hold a mix of solar and wind power assets with a total generation capacity of 1,000MW.

According to Bloomberg, Vedanta Resources Ltd is talking to a group of lenders including Cerberus, Davidson Kempner, Varde and Standard Chartered about a private loan of $1bn. The proceeds will be reportedly used for the partial redemption of Vedanta's bonds that mature in 2024 and 2025.

Moody's has revised its outlook on China Resources Land, China Overseas Land, Poly Real Estate and Greentown to negative. The agency also placed the outlook of Vanke and Jinmao's ratings on review for downgrade. The latest negative ratings action is not surprising. On a sectoral basis, Moody's recently revised the outlook of the Chinese property sector to negative to reflect the weak economic growth outlook as well as homebuyers' concerns over the timeliness of project completion and delivery.

Country Garden has secured the approvals from onshore bondholders to extend the repayment of nine CNY-denominated notes. The company, however, missed the timely payment of a coupon ($415.4m) for a US dollar bond that matures in 2025. There is a 30-day grace period for this payment to be made.

Emerging markets

The EMBI Global index delivered a -0.85% return on the week with spreads widening by 6bps on aggregate. Lower rated African single B names fared the worst with Eastern Europe being the only region that tightened on the week. On the data front we had Qatar's CPI print at 2.38% YoY with Polish CPI coming in slightly below expectations at 10%.

Turkish bonds outperformed, tightening by 18bps as the market becomes increasingly satisfied with the nation's commitment to price stability and orthodox monetary policy. Turkey's five-year credit default swap currently trades at 380bps (it was as high at 700bps during the May election): put another way, the cost of protection against default has now almost halved.

We also had news of India's inclusion in the JP Morgan's family of local currency indices (we use these to benchmark our local EM pooled fund). This will be effective as of June 2024 and India will receive a maximum weighting of 10%. A survey of banks indicated this would lead to a least $20bn worth of flows into Indian local bonds and should be supportive for the rupee.

In Eastern Europe, the Polish prime minister said the country will now stop supplying weapons to Ukraine following the ongoing grain dispute. Poland (as part of a group of five Eastern European nations) recently banned Ukrainian grain imports due to the detrimental impact on local farmers; however, the EU decided not to extend this ban last Friday. Poland has since softened its stance saying this comment referred to new weapons only and older weapons can still be shipped.

Commodities

The BCOM index delivered a -1.1% return on the week with agriculture (-2.3%) and energy markets (-1.4%) seeing the largest losses.

In the energy space the biggest losses were felt in US gasoline prices, which were down 5.2%. In crude, WTI was flat on the week closing at $90 a barrel. Near term pricing has been supported by low inventory levels at the Cushing storage facility with the WTI curve now strongly backwardated.

Looking forward, energy prices could be supported by China's golden week holiday with 21m people expected to fly over the period. In Macao, a popular gambling destination for Chinese tourists, income is expected to recover to 100% of 2019 levels during the holiday.

We had a breakthrough in the LNG space, with Chevron reaching an agreement with unions at its Australian LNG plants, strikes threatening 10% of global LNG supply have now resolved. Less encouragingly Russia announced an indefinite ban on the exports of gasoline and diesel to all countries excluding four ex-soviet states. This follows recent fuel shortages within Russia. The result was European natural gas priced rallied 9.6% last week.

Fixed Income Asset Allocation Views

25th 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 (■ at 0)	■ Valuations continue to be rich overall. Technicals seem stable following seasonal issuance; 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 possible hike left in the hiking cycle. 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 (¥ -1, P -1, $ +1, € +1, £ +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 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 +1 +2 Long (EM, A$, ¥, €, $, £ 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. ■ 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))	Under-weight -2 -1 0 +1 +2 Over-weight (R +1, C +1)	■ 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 (■ at -1)	■ EMD spreads 23bps wider than last month, reversing the early summer rally. Technicals are stable but slow. ■ Conservatively positioned with most idiosyncratic opportunities in lower quality portion of index; 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 (■ at 0)	■ US and EMEA spreads are at similar levels to last month; minor fundamental deterioration at a sector level, but management is positioning conservatively. EUR valuations are attractive; prefer USD and Euro to Sterling. ■ Typical seasonal issuance to start Sept, but less than estimated and skewed towards the shorter end of the curve. Credit metrics are solid amidst recession uncertainty. Fundamental concerns remain focused on commercial real estate for Banking sector, tight labour supply, changing consumer behaviour.	■ 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 (■ at -1)	■ Spreads remain inside historic medians and are roughly unchanged since August. Technicals have been slow but stable, with more issuances in the pipeline. Fundamentals continue deteriorating slightly due to financial conditions, but with no significant impact so far outside of distressed names. ■ Prefer conservative position; open to attractive buying opportunities in short HY & BB's and higher quality loans where financial conditions are less of a headwind. ■ US HY defaults remain below historic averages, with further default expectations now being pushed into 2024. ■ Bank loan market continuing May's rally, with overall market dispersion. Themes: moderating 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. ■ Volatility in the short end of the curve, eroding potential upside where we are positioned for 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. ■ Record low real estate transactions leading to low supply of new MBS. ■ Place to add, prefer high coupon assets; constructive view over longer time horizon.	■ Costlier funding and tighter lending standards from bank crisis ■ Rising rates cause prepayments to normalise without reducing mortgage servicing. ■ 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 (■ at 0)	■ Our preference remains for quality Non-Agency RMBS ■ RMBS: Home prices resilient despite headwinds, but with all-time low transaction activity. Delinquency, prepayment, and foreclosure performance remains strong; difficulty seeing deterioration of home prices given labor market strength. ■ CMBS: We feel cautious, especially on office and multifamily. Delinquencies increasing as maturities come due. Credit curve remains steep. AAAs have mostly retraced post SVB widening, but BBBs remain at widened levels. ■ CLOs: Pick up in new issuances leading to slightly tightened spreads. Defaults remain low. ■ ABS: Attractive relval in some senior positions; higher quality borrowers remain stable, lower quality borrowers continue to underperform. Market is active with 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 ■ Student loan repayments weaken consumer spreads on a secular level. ■ 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 (■ 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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