COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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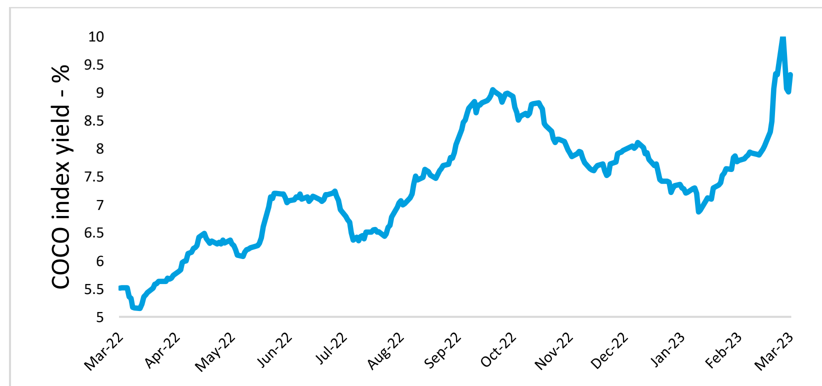
Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	3.46%	3 bps	3.5%	3.7%
German Bund 10 year	2.23%	12 bps	3.9%	3.0%
UK Gilt 10 year	3.39%	11 bps	4.7%	3.9%
Japan 10 year	0.32%	3 bps	1.3%	2.2%
Global Investment Grade	162 bps	-7 bps	2.1%	2.9%
Euro Investment Grade	181 bps	-6 bps	1.4%	2.0%
US Investment Grade	154 bps	-8 bps	2.4%	3.3%
UK Investment Grade	162 bps	-5 bps	2.1%	3.4%
Asia Investment Grade	240 bps	14 bps	2.0%	3.1%
Euro High Yield	541 bps	1 bps	-0.9%	2.2%
US High Yield	522 bps	5 bps	-0.7%	1.8%
Asia High Yield	746 bps	58 bps	-2.7%	2.2%
EM Sovereign	416 bps	-5 bps	1.0%	1.8%
EM Local	6.6%	-6 bps	2.5%	3.5%
EM Corporate	389 bps	8 bps	0.5%	1.9%
Bloomberg Barclays US Munis	3.3%	-7 bps	2.0%	2.5%
Taxable Munis	4.7%	-2 bps	2.1%	5.3%
Bloomberg Barclays US MBS	54 bps	-2 bps	2.9%	3.4%
Bloomberg Commodity Index	226.23	0.5%	-2.6%	-7.7%
EUR	1.0768	0.8%	1.7%	0.5%
JPY	131.51	0.9%	4.2%	0.3%
GBP	1.2260	0.5%	1.8%	1.2%

Source: Bloomberg, Merrill Lynch, as of 24 March 2023.

Chart of the week: Contingent Capital Index yield – LTM



Source: ICE BoML Indices, Columbia Threadneedle Investments, as of 25 March 2023.

Macro / government bonds

Last week was a period of some significant volatility.

Market expectations of interest rates fluctuated with the bond market and kept in time with the sentiment of risk markets. This turbulence had provided hope that the US Federal Reserve bank might pause and reflect on the ‘damage’ done. It did not and interest rates were pushed higher once again. Official rates now rest at 5% for the upper band after nine rates increases in around a year. Rates were only 0.25% at the start of March 2022. But is it the end for rate hikes? The market seems to think so. Rates are now forecast to decline into the year end. The US Fed itself was a bit more circumspect and seemed to suggest it is on a ‘wait and see’ approach. It would seem it is caught in a tug of war between persistent inflation and financial stability.

The Bank of England followed suit and raised the UK base rate to 4.25% in its eleventh increase since December 2021. The Bank had little choice this month, after an outsized inflation report preceded its meeting. Specifically, CPI inflation increased to 10.4% y/y in February, up from 10.1% in January, well above expectations of a 9.9% rise. Core CPI inflation increased to 6.2%, from 5.8%, also above expectations of 5.7%. There was economic good news to end the week, retail sales rose by 1.2%, well above expectations of a 0.2% rise. Meanwhile, the GfK’s index of consumer confidence rose to -36 in March from -38 the prior month.

Bond yields ended the week at the lowest for weeks with the benchmark 10-year US treasury note falling below 3.4%. It had been above 4% at the start of March.

Investment grade credit

Credit markets have been very volatile in March.

Global investment grade spreads ended the week at 162bps in a month where they have been as tight as 135bps and as wide as 170bps. Credit curves have been flattening as short-dated bonds underperformed in spread terms (normal in times of distress). The US market has underperformed its European cousin so far this year, widening by 12% while euro-denominated bonds are only 8% wider. The UK stands out as the clear winner and is 2% tighter in 2023.

On a risk-adjusted, sectoral basis, the winners globally this year have been autos, media and telecoms with, unsurprisingly, banks and other financials underperforming led by CoCo (AT1s) following the Credit Suisse debacle.

In our view, the large banks in Europe and the US are in decent shape. Capital is at multi-decade highs, liquidity buffers are five times bigger than in 2007 and profitability has been improving as interest rates have risen. However, US banks are running with much more interest rate risk in their securities portfolios than European banks: this is especially evident at the US regional banks. But, at the very least, the Credit Suisse situation / resolution suggests future bank unwinds follow a different script. In a world where information is widespread and technology enables money to be moved quickly, maintaining confidence about a bank’s health is paramount. A sound capital position and access to central bank liquidity may not be enough to save a bank. Given this, a higher risk premium may be required for investors providing funding to the sector. The **chart of the week** illustrates the point of the rising cost of this kind of

capital. The yield on the ICE COCO index has risen from around 5% a year ago to touch double that in the last few days.

So, has value returned to the overall market in this volatility? Spreads are wide of five- and 20-year averages by one standard deviation (SDs) and 0.3 SDs respectively. Euro credit looks cheapest, if measured this kind of way.

High yield credit & leveraged loans

It was a week of two halves with a sell-off experienced in the first couple of days, post the weekend's Credit Suisse announcement but then the market recovered in the second half. European High Yield (EHY) basically ended the week unchanged, despite the market volatility in the banking sector and central banks' rate moves. The index yield fell only 2bps to 7.92 while credit spreads widened 1bps to 541bps. That meant performance was finally back into the positive with +21bps return for the week. Still, decompression continued to be the theme as CCCs severely underperformed BBs, with the former returning -1.6% vs +0.28% from BBs. In a market reversal not seen since last year, sterling high yield underperformed EHY for the week. Outflows continued for another week, but with a switch, as ETFs experienced a small amount of inflows, and managed accounts saw net outflows on the back of de-risking. The primary market was quiet with only a last minute Friday offering from IHO Verwaltungs, the German holding company of Schaeffler, with a €500m 5-year bond to partly refinance a 2025 issue. With the final price resulting in yield of 9% (coupon 8.75%), for a BB rated paper, it is indicative of how much investors are still demanding of high rated EHY paper.

In credit rating news, Casino, the French retailer, was downgraded by Moody's to Caa1, from B3, with negative outlook. This happened after news that the firm's cash balance included a revolver, which had not been disclosed before, implying less liquidity available to repay its upcoming 2024 bond. The rationale given for the downgrade was the continued market share loss in French retail as well as continued negative free cash flow in France, which is not expected to change in the next 12-18 months. More positive news came from the travel sector as Avis was upgraded to Ba3 on the back of expectations of continued robust operations despite worsening outlook for earning per day. British Airways's parent company, IAG, was also upgraded to BB+, by S&P, as air traffic continues to recover.

In M&A news, ThyssenKrupp's steel business is being considered a target acquisition by the private equity group CVC. In retail, Asda and EG Group are said to be racing to compete a merger of UK operations by the end of April. Analysis suggests that this deal could raise ASDA's leverage by 2.0x. In telcos, Liberty Global launched an offer to buy Telenet. This finally explained the trading halt on Telenet announced some days earlier.

Structured credit

Agency MBS returned 49bps last week as mortgages enjoyed both a rally in spreads and rates on the flight to quality trade. Because most of the rate rally was on the front end of the curve, 15 years outperformed 30s as did higher versus lower coupons. Ongoing concerns related to future bank demand was offset by the US Fed's commitment to maintain its steady pace of balance sheet wind-down and also the perception that a lot of bad news was already in the price. To wit, 15s and 30s both remain close to historically cheap valuations. Non-agency RMBS spreads were more mixed on heightened risk-off volatlity. AAA was tighter by

approximately 5-15bps, while lower quality and CRT were wider. The most volatile sector was CMBS. Spreads continued to widen down the capital stack and downgrades from the rating agencies outpaced upgrades by 4:1.

Asian credit

Hindustan Zinc Ltd (HZL) is paying its fourth interim dividend of around $1.33bn, which will provide a short-term liquidity relief to its parent companies (Vedanta Ltd and Vedanta Resources Ltd). Vedanta Ltd holds 64.9% in HZL and will receive around $860m from this fourth interim dividend.

China Huarong Asset Management expects to post a net loss of CNY27.6bn in 2022 due to fair value losses on its equity investments, high credit impairment losses and lower revenue from its distressed debt business. Moody's has also put the Baa2 ratings of China Huarong on review for downgrade because the significant net loss has weakened Huarong's equity base and capital positions.

Moody's affirmed the ratings of Melco Resorts and Studio City but kept the ratings outlook on negative. While Moody's expects Melco's financial leverage will improve over the next two-three years, the group's financial leverage will remain high over the next 12-18 months as it takes time for the capital structure to improve.

In Chinese properties, Sino-Ocean deferred the coupon payment on its 6.876% perpetual bonds ($600m), which puts an intense spotlight on its tight liquidity situation in the absence of a strong direct support from its key shareholder, China Life. China Evergrande has also released its offshore restructuring plan with two options for $19bn of bonds. The first option entails the conversion of existing holdings into new notes (10-12 years) with coupons of 2-4%. The second option is the conversion of existing holdings into new notes (5-8 years) with PIK for the first 2.5 years and equity-linked investments.

Emerging markets

Emerging market debt returned 0.7% on the week driven by spread compression, with European names (such as Ukraine) seeing the most tightening.

In ratings news, Argentina (1.5% index weight) was downgraded 2 notches by Fitch to C. Fitch expects a further downgrade to restricted default once recently announced exchanges are carried out. For context, last Thursday Argentina ordered public sector bodies to sell their Argentine government dollar bonds and swap them into local currency bonds following depleted foreign currency reserves. Argentina's CPI currently stands at 102.5% y/y.

In Sri Lanka, the government has secured a $3bn bailout from the IMF as part of a four-year programme. The government aims to raise funds by restructuring state owned enterprises, introducing higher income taxes and privatising its national airline.

Ukraine has also secured an IMF package at $15.6bn in value following Ukraine's GDP shrinking by 30% in 2022.

Commodities

The BCOM index rallied by 0.5% on the week with industrial and precious metals seeing the largest gains. Agricultural markets saw the most weakness, down 1.7%.

In crude products, Russian exports of diesel are on track for the highest month since 2016, despite EU sanctions. Shipments are being sold at a discount to the likes of Turkey, Morocco, Brazil and Tunisia.

Spot gold was flat on the week but is currently trading at elevated levels of around $1,950 per oz, representing a 7.5% rally since the start of the SVB trouble.

Responsible Investments

A mass of ESG fund rating downgrades are expected as MSCI has reviewed the strength of its fund ratings and plans to re-evaluate each fund, ETF and mutual fund it rates from an ESG perspective. It’s expected that 73% of current ratings will fall. Currently, MSCI provides an ESG rating on a fund at a holdings level and adjusts for exposure to companies who have an improving ESG rating, often raising the overall rating of the fund. The new change will remove this adjustment, taking only into account the underlying holdings. Some ESG specialists are calling the change long overdue, especially at a time when more and more regulations are in force to protect investors from greenwashing.

Fixed Income Asset Allocation Views

27th 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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