In Credit

28 November 2022

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Macro / Government bonds, Investment Grade Credit

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Emerging Markets

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Asian Fixed Income

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Responsible Investments

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Commodities
Emerging Markets

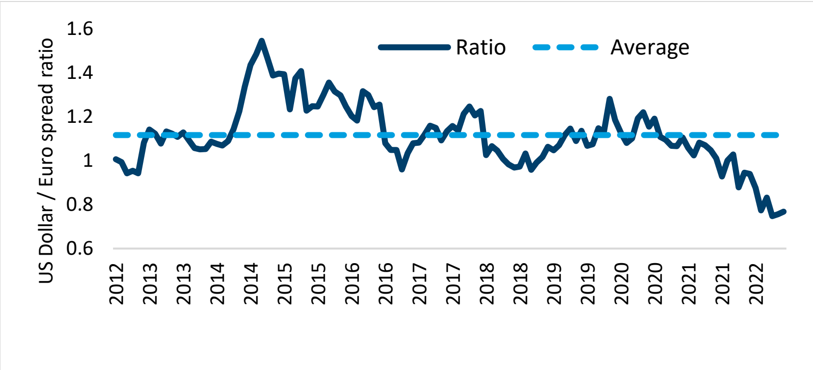
Credit markets rebound.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.68%	-15 bps	1.0%	-12.6%
German Bund 10 year	2.00%	-1 bps	1.0%	-14.5%
UK Gilt 10 year	3.15%	-9 bps	7.2%	-21.0%
Japan 10 year	0.25%	0 bps	1.4%	-4.0%
Global Investment Grade	153 bps	-6 bps	3.3%	-14.3%
Euro Investment Grade	178 bps	-9 bps	2.7%	-12.8%
US Investment Grade	140 bps	-5 bps	3.6%	-15.4%
UK Investment Grade	167 bps	-6 bps	8.4%	-16.1%
Asia Investment Grade	245 bps	-18 bps	0.0%	-11.0%
Euro High Yield	513 bps	-32 bps	5.7%	-10.8%
US High Yield	452 bps	-13 bps	4.7%	-10.6%
Asia High Yield	1000 bps	-109 bps	2.2%	-21.3%
EM Sovereign	400 bps	-6 bps	6.3%	-17.4%
EM Local	7.0%	-10 bps	5.5%	-14.1%
EM Corporate	399 bps	-4 bps	2.2%	-14.3%
Bloomberg Barclays US Munis	3.6%	-7 bps	3.2%	-9.3%
Taxable Munis	5.2%	-14 bps	2.4%	-20.4%
Bloomberg Barclays US MBS	47 bps	-5 bps	2.5%	-11.5%
Bloomberg Commodity Index	246.86	0.2%	3.7%	17.8%
EUR	1.0425	0.7%	6.0%	-8.6%
JPY	138.59	0.8%	4.0%	-17.3%
GBP	1.2046	1.7%	8.3%	-10.6%

Source: Bloomberg, Merrill Lynch, as at 25 November 2022.

Chart of the week 1: USD/Euro IG spread ratio – last 10 years



Source: Bloomberg, Columbia Threadneedle Investments, as at 31 October 2022.

Chart of the week 2: Oil in 2022

Source: Bloomberg, Macrobond and Columbia Threadneedle Investments, as at 28 November 2022.

Macro / government bonds

Government markets traded more strongly in a quiet week. The benchmark 10-year US treasury note lost around 15bps in yield over the week.

The US Thanksgiving holiday and the start of the football World Cup in Qatar competed for attention in the last seven days. I'm not sure which won, though the victories of Saudi Arabia, Japan and Morocco against much fancied Argentina, Germany and Belgium were notable highlights for me.

Of more market relevance, the FOMC minutes offered the expectation that the present rapid rise in US rates is likely to be more restrained going forward. A reduction to a 0.5% rise in December is being flagged after several 75bps hikes. We also saw more likelihood that the terminal rate in this present cycle should be around 5%. Markets are currently priced for this eventuality. Through the week rate expectations have fallen somewhat with 23 June now priced below 5%. US Federal Reserve Chair Powell will make a speech this week so there may be some clarity on the Fed's present thinking. It is worth noting that in the last few weeks financial conditions have eased, which might be a worry to the Fed.

PMI business sentiment data and consumer confidence were weak data releases in Europe last week. They both point to near recessionary conditions but were not as weak as very pessimistic expectations. In further evidence of bad news – but less bad news than feared – the IFO Business Climate Index in Germany rose to 86.3 in November from 84.5 the prior month. Finally, the German economy expanded by a modest 0.3% in Q3, 2022, driven by household consumption.

Investment grade credit

Since the difficult days of early October, credit markets have delivered some more impressive returns. Fuelled by falling government yields and augmented by tightening credit spreads recent positive returns are starting to eat into the damage inflicted earlier in the year.

Euro credit stands out as the best performer recently and remains our favoured area globally. Spreads had widened far more than has been the case for the US market and some reversion was expected. Typically, in the last decade, the US dollar IG spread has traded wide to its euro cousin. The ratio has on average been around 1.1 times to be precise. Since the end of 2020, fortunes have reversed, and the US market has become the more expensive market. Indeed, as can be seen in **(see chart of the week 1)** the ratio became so extreme that US dollar credit was trading less than 0.8 times the spread of euro credit.

High yield credit & leveraged loans

European High Yield (EHY) had a strong week, returning +1.3%. It was the fifth week of positive returns as lower rated credits outperformed, while sterling high yield modestly outperformed EHY. Spreads tightened 35bps to 513bps and was the prime reason for the fall in yields to 7.44%. It was second week of positive flows with €215m added to high yield. The corporate primary market remained subdued with only one offering from Valeo, the French auto part company, a sustainability-linked bond of €750m (upsized from €500m) coming in at 5.375% coupon, quite a bit tighter from the initial price talk of 6%. The bond was well oversubscribed with books at €3.3bn. Market liquidity remains relatively poor.

A new Fallen Angel last week was Wizz Air, the Polish discount airline, downgraded by Moody's to Ba1. Another downgrade saw Fitch lower Boparan (UK chicken supplier) from B to B- citing delays to deleveraging and profitability on concern of a weak economic environment.

In sector news, leisure parks reported good third quarter figures with Center Parcs reporting levels back to pre-covid terms. Merlin Entertainments (Legoland, Madame Tussaud, etc.) said they had their best summer yet, ahead of 2019 levels, with revenue up 16+% for the summer.

In issuer specific news, Adler announced it has agreement already with 45% bondholders for a restructuring. The plan is for collateralisation of the debt, deferral of interest payments, extension of maturity and adding 2.75% increase in the interest rate on the bonds with 2023 and 2024 bonds paid out at par. Bonds were up more than 10 points on the news.

Asian credit

In Chinese properties, the largest state-owned banks have offered at least CNY1.28trn (c$179bn) in new credit lines to 17 real estate companies. The credit lines include, among others, mortgage loans, construction loans, M&A loans, letters of guarantee and bond underwriting. The 17 companies include six privately-owned developers such as Country Garden, Hopson, Longfor, Midea, Radiance and Dahua.

In Macau, the six incumbent casino operators have won the concessions to continue their gaming operations for the next 10 years. The seventh bidder, GMM Ltd, which is linked to Genting Group was unsuccessful in its bid. The outcome of the concession renewal removes the material regulatory overhang in the sector. The considerations in granting the new concessions include the ability of the concession bidders to ensure local employments, develop the market for incoming foreign tourists and invest in non-gaming segments.

Meituan's Q3,2022 operating performance was strong, driven by its core local commerce segment and the flat q/q operating loss in its new initiatives segment. The company posted its first positive quarterly operating profit since Q3, 2020, thanks to the resilient performance of its core businesses and the sharply y/y lower operating loss at its new initiatives segment (-0.3% q/q, -63% y/y to CNY6.77bn). Its liquidity position remained strong with a net cash position of CNY45.5bn (Dec 2021: CNY57.9bn).

Emerging markets

Another positive week of returns for emerging market debt as the index returned +1.54% with strong performance across the board. Spreads ended the week at 400bps above US treasuries. The yield on the index was 7.9%.

Oman was upgraded to BB by S&P as oil prices and the government's fiscal reform programme are strengthening fiscal and external metrics. Continuing with positive momentum in the Middle East, Bahrain's outlook was upgraded by the same ratings agency, the higher oil price also helping to reduce the budget deficit there.

South Africa hiked 75bps as expected to 7% as inflation stands at 7.6%. Turkey continued its contrarian action with a 150bps cut to 9% despite inflation exceeding 85%.

Ghana proposed a debt restructuring where bond holders will be asked to forgo some interest payments as it attempts to secure a $3bn loan from the IMF. Its currency, the cedi, is the world's worst performing currency this year, making it even harder to service existing debt. Spreads are trading at severely distressed levels

Last week we had positive news for China: state owned banks announced $30bn in credit lines to support stronger property companies (such as Longfor, Country Garden and Vanke). We also had a reserve requirement ratio (RRR rate) cut from the PBOC of 25bps that will inject $70bn of liquidity into the economy. As a result, Chinese high yield credit rallied 8.9% on the week.

Sentiment has now soured, with at least 10 Chinese cities protesting strict covid controls and suppressed freedom of speech. This resulted in clashes with the police and arrests, including of a BBC journalist. China is now stuck between a rock and a hard place; vaccination rates, hospital capacity and natural immunity are comparably low, so easing too much would risk squandering the achievements of zero covid. Alternatively, cracking down too hard on protesters could risk widespread social unrest.

Commodities

Energy markets rallied over the last week, driven by US natural gas prices surging 9.1%, while elsewhere brent declined by 3.5%. The decline in crude comes as movement in key Chinese cities was dramatically restricted because of covid controls. Crude extended its sell-off on Monday morning following news of the Chinese anti-covid restrictions protests. Brent has now given back almost all of its gains in 2022 **(see chart of the week 2)** driven in large part by the negative outlook in China and global recessionary concerns. On the supply side, Chevron has received a 6-month licence to resume oil production in Venezuela and sell crude back to the US. 2019 sanctions meant Chevron was only allowed to maintain its assets in Venezuela and not export or expand operations.

Turning to Europe, the EU is mulling the correct levels for its proposed oil and gas price caps on Russia. The crude cap has generally been proposed in the $65-70 range, above where Russian crude currently sells; furthermore, Russia has pledged to not sell to any nation who enforces the price cap. The gas cap currently focuses on the Dutch TTF facility and was proposed at a price of €275, a far cry from current prices of €125 and only exceeded during the recent price spike in August. The cap of €275 has been called a “mockery” by Spain and “a joke” by Poland.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views
28th November 2022

COLUMBIA THREADNEEDLE INVESTMENTS

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 more attractive since October, as volatility came off 2022 highs and signs of improvement came from technicals and fundamentals. The group is now neutral on credit risk, upgrading Investment Grade and High Yield. ▪ We are past the peak of economic growth, with expectations for more 50bp hikes through 2H 2023, followed by multiple cuts in 2023. Pullback in liquidity created opportunity for market volatility. ▪ 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)	¥ P $ Short -2 -1 0 +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 premiu ▪ Long run trend in safe asset demand reverse
Currency ('E' = European Economic Area)	¥ A$ EM Short -2 -1 0 +1 +2 Long $ €£	▪ The invasion of Ukraine will hit global growth, hinder risk markets and lend a bid to the Dollar ▪ The repricing of the ECB has so far failed to boost the Euro as Eurozone growth expectations have underperformed the US	▪ End of zero-covid strategy in China normalises supply chains and raises global growth, to the detriment of the Dollar
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	▪ 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 counte 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; continued outperformance in HY, high-beta credits ▪ Fundamental headwinds: elevated fiscal deficits, rising debt to GDP ratios, significant inflation, central bank tightening, China lockdown/growth, 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 postponed – 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 tightened since October. ▪ 3Q earnings met and management commentary exceeded expectations. Inflation, labor supply, low dispersion and monetary tightening continue to pressure margins and operating environment. ▪ Technicals have started to improve, with the long end outperforming the widening in spread terms	▪ M&A expected to slow; cash flow prioritizing shareholder payouts ▪ Market indigestion as central banks sell EME 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 hikir 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 at summer lows. Better relval elsewhere, continue to trim. ▪ CLOs: AAA spreads modestly tighter, Mezz spreads firming along with macro. Default rate low but 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 Fe 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
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper ▪ o/w Softs ▪ u/w Gold ▪ u/w Oil ▪ u/w Silver	▪ Global Recession