COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

31 July 2023

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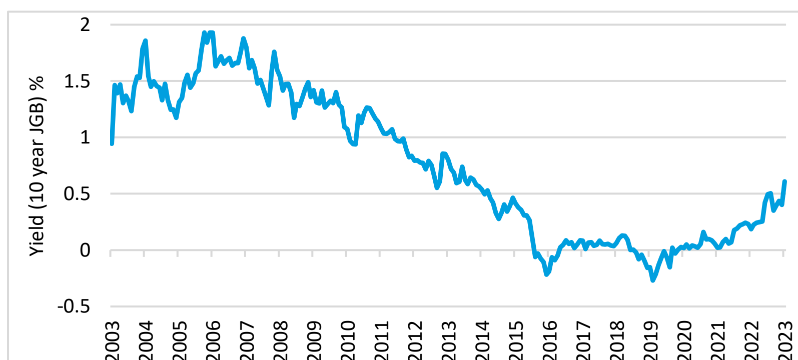
Land of the rising yield.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.98%	15 bps	-0.5%	1.1%
German Bund 10 year	2.53%	6 bps	-0.4%	0.8%
UK Gilt 10 year	4.36%	8 bps	0.5%	-3.3%
Japan 10 year	0.61%	16 bps	-0.9%	1.8%
Global Investment Grade	129 bps	-5 bps	0.4%	3.2%
Euro Investment Grade	147 bps	-3 bps	0.9%	3.0%
US Investment Grade	119 bps	-7 bps	0.2%	3.5%
UK Investment Grade	131 bps	-3 bps	1.8%	0.7%
Asia Investment Grade	197 bps	-3 bps	0.4%	3.5%
Euro High Yield	446 bps	-9 bps	1.1%	5.5%
US High Yield	382 bps	-7 bps	1.2%	6.7%
Asia High Yield	839 bps	-9 bps	-1.3%	-1.5%
EM Sovereign	339 bps	-12 bps	1.3%	5.2%
EM Local	6.3%	2 bps	2.8%	10.8%
EM Corporate	330 bps	-9 bps	0.8%	4.5%
Bloomberg Barclays US Munis	3.5%	6 bps	0.4%	3.1%
Taxable Munis	5.1%	9 bps	-0.7%	4.3%
Bloomberg Barclays US MBS	48 bps	-5 bps	-0.1%	1.7%
Bloomberg Commodity Index	240.24	1.1%	6.1%	-2.2%
EUR	1.1034	-1.0%	1.0%	2.9%
JPY	142.29	0.4%	2.2%	-7.1%
GBP	1.2857	0.0%	1.2%	6.4%

Source: Bloomberg, Merrill Lynch, as of 28 July 2023.

Chart of the week: Japanese bond yields start to rise….at last!



Source: Bloomberg and Columbia Threadneedle Investments, as of 31 July 2023.

Macro / government bonds

Bond yields were meaningfully higher in the last week.

Better news in terms of stronger US GDP, a change to the yield curve control in Japan and rate rises in the US and Europe saw an unwind of the recent rally in bond markets. Once again, US government yields are at or around 4% having being as low as 3.75% in mid July.

US rates were increased, as expected, to 5.25-5.5% with a terminal rate now seen at around 5.4% by the end of 2023. In other words not much more to come – though data dependent. Last week also saw further signs of ebbing inflation pressure with lower emplyment costs and personal consumption expenditure data. This week brings key US employment data as well as the Senior Loan Officer survey where we shall be looking for signs of tighter lending conditions.

In the UK, the Bank of England will probably increase its own interest rate by 25bps though some fear that labour market strength / tightness suggests a move of 50bps. This would be the 14th such increase in this cycle and take UK interest rates to 5.25%.

In Europe, there is also economic growth and inflation news released this week. The consensus view is that the European economy will expand albeit modestly by around 0.2% in the second quarter. Inflation is also expected to fall again modestly.

The biggest news last week was a change to monetary policy in Japan. The Bank of Japan will now allow 10-year government bond yields to trade with a yield in excess of 0.5% with a cap of 1% in a tweak to yield curve control (following stronger Japanese inflation). This saw JGB yields trade above 0.6% from less than 0.5% at the end of the prior week **(see chart of the week**). The policy change is being seen as a sign of normalisation is a country where bond yields were below 0% as recently as 2019.

Investment grade credit

While government bond markets saw negative returns last week, credit spreads continued to tighten. The global investment grade index, which traded with a spread as wide as 170bps in March has recovered to such an extent that spreads were inside 130bps by the end of the week according to data from ICE indices. This means that the spread is within 'a whisker' of the tightest spreads of the year (127bps). US dollar spreads have edged their euro-denominated cousins as the winner in terms of tightening with spreads around 14% tighter. Global spreads are close to both short and longer-term averages, though yields are clearly well above average.

Market 'technicals' remain supportive with a light calendar of primary issuance and ongoing inflows into the market.

In recent weeks, and after underperformance, the real estate sector was the main outperformer while there were strong numbers from European banks including Intesa and Bank of Ireland.This week sees a continuation of the earnings season with Apple, Amazon and Qualcomm amongst those scheduled to report.

High yield credit & leveraged loans

US high yield spreads tightened to the lowest level since April 2022 as investors absorbed better-than-expected earnings, US data indicating growth resilience, and moderating inflation data. The ICE BofA US HY CP Constrained Index returned 0.09% and spreads were 6bps tighter. The asset class experienced a $376m retail fund outflow (source: Lipper). Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index was unchanged at $94.80 amid a stall in retail fund withdrawals and still elevated yields (9.39% YTM). Retail loan funds saw a $58m withdrawal.

It was a solid week for European High Yield (EHY) as the asset class returned 0.43% taking the MTD performance to 1.1%. Decompression continued but at a much softer pace with CCCs only marginally underperforming higher-rated credits. Sterling high yield had another strong week, as it continued to outperform EHY – MTD figures suggest that June could show sterling high yield outperforming EHY by 100%. Flows were modestly negative, with inflows into ETFs and short duration accounts not quite offsetting the outflows of managed accounts. The primary market was very quiet (its quietest week since 2020) given the summer slowdown and as the market digested the latest ECB rate hike given the comments that the ECB may be coming to the end of its rate hiking cycle. This takes net issuance to just €3.5bn YTD given €37bn gross issuance.

In credit rating change news, the Swedish real estate group SSB saw its rating cut for the third time this year as S&P downgraded it four notches to CCC+ (from BB-), with negative outlook. S&P noted the upcoming maturities could "weigh on the company's liquidity position". In telecoms, Digi Communications saw its corporate family rating deteriorate to B1 (from Ba3) as Moody's cited an expectation of weakening of the company's creditworthiness in the next year to a year and a half on the back of "higher capex associated with its growth strategy."

In sector news, auto results were largely very good with FY23 outlook guidance raised or maintained. Ford, Dana, Renault and Faurecia all beat expectations while others (Valeo, Volvo, JLR) kept their outlooks unchanged. Telecoms saw a number of earnings reports (eg, Telefonica, Vodafone, Virgin Media), which all showed solid results coming in better than expected. Also positive for the sector was the announcement by S&P that in spite of the negative news regarding Altice's co-founder and former COO, Armando Pereira, the rating agency would not change its opinion regarding governance nor does it see the issue materially impacting its view of the company's creditworthiness. The chemical sector continues to show further weakness with softer outlooks now being mentioned. To no surprise, the spread between autos and chemicals sectors continues to widen.

Structured credit

As spreads remained relatively stable, performance in Agency MBS last week was mostly about the rise in interest rates.

The Basel III Endgame proposal appears a bit more stringent than expectations and will likely lead to tighter lending standards with less room to ease, less bank origination in high-LTV loans, and higher securitization rates – a positive for structured credit, particularly in non-agency.

In housing, the FHFA House Price Index showed higher prices in eight of nine regions and +2.8% y/y. New home sales were down on limited existing home inventory and pending home sales were actually up a little (the first time in four months) despite supply and financing headwinds. In CMBS, the primary market remained subdued and downgrades continued to outpace upgrades.

Asian credit

According to SCMP, US President Biden is planning to sign an Executive Order to constrain US technology investments in China by mid-August. The Executive Order will reportedly focus on semiconductors, artificial intelligence and quantum computing. This is a follow-up development from the programme being considered by the US Treasury Department and the National Security Agency to restrict more outbound US investments in China, especially in sensitive technologies with national security ramifications. According to previous statements by the US Treasury Department, any new rules will be targeted and narrowly scoped.

Hon Hai Technology Group (Foxconn) announced a 50/50 joint venture with ZF Friedrichshafen AG (ZF Group), one of the world's largest automotive suppliers. Specifically, Foxconn will acquire a 50% stake in ZF Chassis Modules GmbH, which is involved in the assembly of passenger car axle systems for around €560m in common stock.

SK Hynix released its Q2/23 results with a net loss of around KRW 3trn (Q1 – KRW 2.8trn), a third straight quarterly loss due to the delayed recovery in the memory chip demand. That said, the loss has narrowed, thanks to strong demand for HBM and DDR5. SK Hynix plans to expand in high-end products (AI related) to boost growth.

S&P upgraded Delhi International Airport Ltd to B+ with a positive outlook, thanks to the traffic recovery and cash flow from contracted land monetization that will improve the profitability and debt servicing ability of the company. S&P has also upgraded Sands China from BB+ (positive outlook) to BBB- (stable outlook) given the rapid recovery in gross gaming revenue.

Emerging markets

The EMBIG index delivered a +0.2% return as spreads tightened by 12bps to 339bps with African and high yield 'names' outperforming. EM bond funds have delivered +$334m of inflows, with hard currency funds seeing the strongest flows.

Chile produced a larger than expected 100bps rate cut. This was Chile's first cut of the cycle, with inflation expected to hit its 3% target within 12 months and growth forecasted at near zero. Costa Rica also cut rates by 50bps. Other South American economies are expected to cut rates in the near term following aggressive rate hiking during the pandemic.

In credit ratings news, Brazil was upgraded by Fitch to BB from BB- on fiscal reform progress. A proposal to overhaul Brazil's tax rules was approved by its lower house earlier this month.

Argentina has reached a staff level agreement with the IMF to unlock around $7.5bn, which will allow Argentina to cover its 2023 debt payments. As part of the agreement the IMF relaxed some requirements following a devastating drought impacting exports and fiscal revenues. However, the IMF requires Argentina to keep real interest rates positive to support the peso. Argentina is currently in the unfortunate position of having no liquid currency reserves.

Commodities

The BCOM index returned 1.1% on the week led by gains in energy (+3.5%) and industrial metals (+3.2%).

Brent oil had its strongest monthly performance since January, rallying by 4.2% on the week and 13.7% on the month. The follows the recent news of Saudi Arabia extending its supply cuts and Russia announcing a 500k barrels a day cut to crude exports for August. Crude oil demand is expected to exceed the all-time high set in 2019 supported by summer travel via car and aircraft. Despite the EV boom, gasoline demand has been supported by a growing absolute number of gasoline cars with consumers delaying the purchase of more fuel-efficient models.

Glencore has purchased a $475m stake in an Argentinian copper project from Pan American Silver Corp. This follows recent attempts by Glencore to buy the copper assets of Canadian miner Teck Resources.

The Rhine river's water levels have now recovered following the recent drop to critical levels, where a typical barge can only carry 50% of its maximum cargo. German companies are exploring contingency plans including shifting production and re-routing logistics to land.

Fixed Income Asset Allocation Views

31st July 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 tightened recently but remain wide of February's market. Technicals have stabilised, fundamentals remain a headwind. **The Group stands neutral on Credit risk overall favouring higher quality sectors.** ▪ The Fed Funds market is pricing in a peak of 5.4% and rates being cut to 5.4% in 2023. This market has been volatile, with the first full cut not priced until 2024 ▪ The CTI Global Rates base case view is no cuts in 2023, with one or two more cuts before holding to end the year. Focus remains on wages, financial conditions, and inflation expectations. ▪ Uncertainty remains elevated due to pullbacks in lending surrounding banking crisis, monetary policy schedules, recession probabilities, persisting inflation, weakening consumer profile and ongoing geopolitical tension.	▪ Upside risks: the Fed achieves a soft landing with no labour softening, banking crisis eases with no lasting changes to fundamentals, consumer retains strength, end of Russian Invasion of Ukraine ▪ Downside risks: additional bank failures, simultaneous low unemployment, high inflation, hiking and slowing growth cause a recession. Russian invasion spills into broader global/China turmoil. Supply chain disruptions, inflation, volatility, commodity shocks reemerge.
Duration (10-year) ('P' = Periphery)	¥ $ Short -2 -1 0 +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	▪ 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)	EM A$ ¥ 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 ▪ 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	▪ EMD spreads continue tightening, with destressed credits leading the rally. Technicals have stabilised. ▪ Maintaining conservative positioning, opportunities at idiosyncratic level, but 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 reopening stall. ▪ 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	▪ US and EMEA spreads have tightened since last month; with fundamentals mixed versus pre-COVID. EUR valuations are cheap, prefer USD and EUR to sterling ▪ YTD net issuance greater than last year, held back most by financials, but expect to pick up in 2H23. Focus on earnings, and gauging credit metrics admid recession uncertainty. Fundamental concerns remain focused on commercial real estate for Banking sector, tight labour supply, weaker consumer, recession concerns.	▪ 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	▪ Spreads continue to tightening with valuations inside historic medians. Unchanged fundamentals and technical ▪ Prefer conservative position while open to attractive buying opportunities, especially in short HY & BB's. ▪ US HY defaults higher than last year but still at reasonable levels, possibly normalising to historic trends. ▪ Bank loan market has widened along with other credit sectors. Themes: retail fund outflows, rising defaults, limited issuance, 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
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Mortgage index tightening from last month but remain wide of historic levels, the group sought to capitalise recent outperformance. ▪ Supply below expectations from rates but improving with seasonals. Liquidation of failed banks better than feared. ▪ Place to add, prefer high quality and higher coupon assets; constructive view over longer time horizon	▪ Costlier funding and tighter lending standards from bank crisis ▪ Housing activity slows and rising rates move prepays to normal levels without hurting mortgage servicing rates ▪ Fed continues to shrink position
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Our preference remains for quality Non-Agency RMBS ▪ RMBS: Home prices resilient despite headwinds. Delinquency, prepayment, and foreclosure performance remains strong; need labor market weakness to see housing deterioration. Risk premiums still cheap to LT avg. ▪ CMBS: We feel cautious, especially on office and multifamily. Credit curve is very steep; non-office sectors remain stable. Delinquencies increasing as maturities come due and floating rate debt becomes more expensive. ▪ CLOs: Spreads have tightened since June. Downgrades outpacing upgrades. More tail risks for subordinate bonds. 2023 supply estimate revised lower. ▪ ABS: Attractive relval in some senior positions; higher quality borrowers remain stable. Market is active	▪ 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 ▪ Rising interest rates dent housing market strength and turn home prices negative in 2H23. ▪ Cross sector contagion from CRE weakness.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper ▪ o/w Grains ▪ u/w Gold ▪ o/w Soybean Meal ▪ o/w Oil ▪ u/w Silver ▪ o/w Aluminium ▪ o/w Corn ▪ o/w Lead	▪ Global Recession

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