In Credit

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Structured Credit

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Responsible Investments
Investment Grade Credit

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Commodities
Emerging Markets

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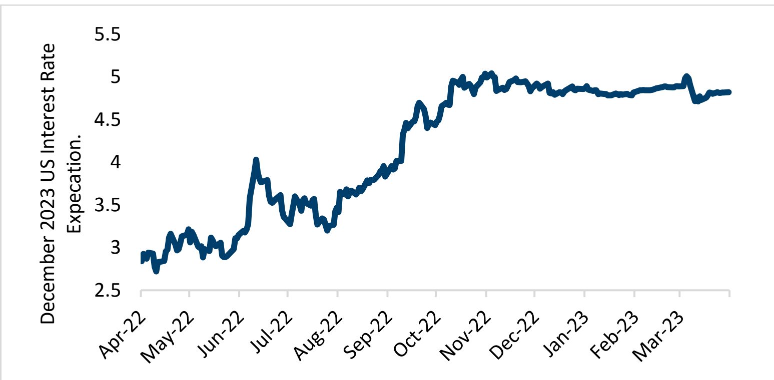
Caught in a tug of war.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	3.40%	3 bps	3.0%	3.1%
German Bund 10 year	2.24%	11 bps	2.4%	1.5%
UK Gilt 10 year	3.40%	12 bps	3.0%	2.2%
Japan 10 year	0.39%	8 bps	1.4%	2.3%
Global Investment Grade	153 bps	-9 bps	2.0%	2.8%
Euro Investment Grade	168 bps	-13 bps	1.0%	1.6%
US Investment Grade	145 bps	-9 bps	2.6%	3.4%
UK Investment Grade	159 bps	-3 bps	1.1%	2.4%
Asia Investment Grade	223 bps	-17 bps	1.2%	2.3%
Euro High Yield	492 bps	-49 bps	-0.2%	2.9%
US High Yield	458 bps	-64 bps	1.1%	3.7%
Asia High Yield	716 bps	-30 bps	-2.0%	2.9%
EM Sovereign	400 bps	-16 bps	1.4%	2.2%
EM Local	6.6%	0 bps	4.1%	5.2%
EM Corporate	375 bps	-14 bps	0.8%	2.2%
Bloomberg Barclays US Munis	3.3%	-3 bps	2.2%	2.8%
Taxable Munis	4.8%	6 bps	2.2%	5.4%
Bloomberg Barclays US MBS	63 bps	9 bps	1.9%	2.5%
Bloomberg Commodity Index	234.92	2.5%	-0.2%	-5.4%
EUR	1.0880	0.7%	2.5%	1.3%
JPY	132.28	-1.6%	2.5%	-1.3%
GBP	1.2382	0.9%	2.6%	2.1%

Source: Bloomberg, Merrill Lynch, as of 31 March 2023.

Chart of the week: US interest rate expectations – December 2023.



Source: Bloomberg, Columbia Threadneedle Investments, as of 3 April 2023.

Macro / government bonds

It was a reasonably good quarter for total returns in the government bonds market. The US Treasury index produced a return of over 3% according to ICE indices.

Yields were lower, especially in March. This move was driven by increased concerns about financial stability after some high-profile banking sector failures in the US and Europe. This distress might suggest that interest rates have been moved too far, too quickly. However, inflation remains troublesome, persistent and too high for most central banks. That underlines the necessity of ongoing monetary tightness or even further increases in interest rates in the coming quarter. The US Federal Reserve and the ECB are both seemingly suggesting the future direction of interest rates is data dependent in the near term. Was it not ever thus? US interest rate expectations for end 2023 **(see Chart of the week)** were lower in the month but have been around 5% since October of last year.

In the US, the fall in bond yields was led by larger moves in the ‘belly’ of the curve (5-10 years) rather than in the ‘wings’. The decline was led by falling real yields as there was not a notable move in long run inflation expectations. There was a similar picture in Europe and the UK where lower yields were also led by falling real yields. Inflation expectations rose slightly by 10-20bps in the quarter. Peripheral spreads also tightened to German Bunds and by around 15% for Italian BTPs.

From an economic background viewpoint, we saw increased expectations around economic growth in the first quarter which led to a consensus view that the US would grow by 0.9% this year while the eurozone saw the biggest increase in economic optimism with an expectation of a 0.5% increase in GDP. This a change from last year’s fears of recession in 2023. Unemployment rates remain very low indeed and at around the tightest levels for over 50 years in the US, though there are some signs of softening as we ended the quarter (eg, Initial Jobless Claims). Inflation continued to fall in all regions led lower by falling energy prices. Gas prices are some 40-50% lower in the last three months while oil prices declined by around 8%. All in, headline US consumer prices inflation (CPI) has declined from 9% in the middle of last year to 6% in the most recent reading.

Investment grade credit

Positive market returns in the first quarter were brought about by a reduction in government bonds yields rather than any tightening in credit spreads. The Global Index total return was just shy of 3% though the market delivered negative excess returns (to government bonds) in February and March according to data from ICE indices.

Euro and sterling market spreads were little moved (euro) or tighter (sterling) while the US market underperformed: especially short-dated bonds where spreads widened by over 15% according to data from ICE indices. At a global level, spreads ended March around 4% wider than at the end of 2022, though the amplitude of spread moves was heightened with a range of 127bps to 170bps through the quarter.

On a sector basis, and in the wake of the failure of SVB and Signature banks in the US and Credit Suisse in Europe, bank spreads were weaker and wider especially for the AT1 section of this sector (after CS AT1 debt was written down to zero). Real estate and insurance sectors were also weaker and wider. Moving in the opposite direction, with tighter spreads were autos, media and telecom bonds. From a rating perspective, globally, all ratings buckets saw wider spreads, though on a risk-adjusted basis BBB rated debt performed least badly.

Turning to market valuations, global markets are now supported by spreads that are around 0.8 standard deviations (SDs) wide of shorter-term averages (five years) and 0.2 SDs wide from a longer-term, 20-year perspective. Regionally, eurozone and sterling spreads look cheaper to those averages than US dollar debt. Adjusting for shifting credit quality though the last few years, BBB spreads are more like 0.7 and 0.0 SDs cheap when considered globally.

High yield credit & leveraged loans

US high yield bond prices recovered over the past week amid diminishing fears of broader contagion from the banking turmoil. The first capital market activity since 2 March surfaced with two deals for $600m pricing. The ICE BofA US HY CP Constrained Index returned 1.83% and spreads were 65bps tighter. According to Lipper, the asset class reported a $2.1bn outflow, leaving YTD outflows at $16bn.

Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index recouped $0.62 of the $1.54 decline between 3/9 and 3/24 over the week. Loan retail fund outflows continued with a $712m withdrawal over the week, which left YTD outflows at $9.3bn.

It was a positive week for European High Yield (EHY) (return of +0.69bps) as spreads tightened in (-49bps to 492) and yields fell (-22bps to 7.70%) as the market recovered from the previous week's banking sector worries. That meant that the month's performance, though negative, still recovered much of the loss from the earlier part of March and the quarter ended with a performance of almost +3%. The decompression theme remained unchanged as CCCs continued to underperform higher rated credits. For the second week in a row, sterling high yield underperformed EHY. EHY finished with a net outflow for March as it was another week of outflows, though down to a trickle, with ETFs seeing strong net inflows while managed accounts flow was more two way but still ended net negative. The primary market saw last week's IHO Verwaltungs deal (€500m 5-year, 8.75% coupon) tapped by the issuer for another €300m, this time offering at a price of 101.00 and still well received. This will allow the company to fully redeem its 2025 bond (€800m).

Despite the recent market volatility, news in the asset class has been relatively positive with several credit ratings announced this week. Dufry was upgraded to BB- from B+ on strong results and positive expectations regarding the Autogrill acquisitions. Netflix was upgraded to Baa3 by Moody's, already at BBB- with S&P and will leave the high yield universe. Paprec, the paper packaging company, was upgraded to Ba3 from B1 while Schaeffler became the latest rising star as it was upgraded to Baa3 with a stable outlook.

In M&A news, SCS and Intel are talking about merging, again. Medical Properties, possibly responding to the recent negative news, confirmed that it is selling its Australian assets to an Australian infrastructure investor for A$1.2bn. This sale should help with liquidity. In the fast-food world, the Issa Brothers (who are behind EG Group) announced it is bidding for Subway, the world's largest food chain for £8bn. This comes at an interesting time given the talk of ASDA and EG Group's talk of merging petrol stations.

Given the paucity of new issues, the is talk that some of the hung deals of 2022 may finally come to market. Some names cited include Citrix and Twitter.

Structured credit

Higher rates in the belly of the curve and wider spreads given near-term risks led to underperformance in the Agency MBS sector last week. The sector was down 88bps, almost 2x the level of the broader high quality fixed income market. Investors sought higher compensation for recent FDIC events including the absorption of $120bn of agency MBS off SVB and SBNY balance sheets and how those securities would be treated – held for a period of time or liquidated. 15-year and higher coupon mortgages with lower durations outperformed. S&P Core Logic also released January home price data evidencing the seventh consecutive month of declining prices, down 0.4%. YoY prices, however, are still marginally positive, up 3.8%. In CMBS, the story is mostly focused on continued concern for the office segment. Last week, 35 bonds were downgraded, the majority of which were office properties. CMBX has been particularly soft, with BBBs now pricing in considerable bad news.

Asian credit

According to China Real Estate Information Corp (CRIC), the momentum of new home sales accelerated in March 2023. The value of new home sales by the largest 100 real estate developers rose 29.2% y/y to CNY660.9bn, higher than the 15% y/y growth in February 2023.

Alibaba Group announced a major restructuring which will involve the spin-off of six business groups – Cloud Intelligence Group, Taobao Tmall Business Group, Local Services Group, Global Digital Business Group, Cainiao Smart Logistics and the Digital Media and Entertainment Group. Alibaba will become the holding company and the controlling shareholder of these six business groups. Each business group will have its own Board and governance structure. Five of the business groups (except Tmall and Taobao) may also pursue potential listings in the future.

Moody's has revised its outlook of Meituan from negative to stable to reflect the potential for Meituan's financial profile to recover on higher profitability and earnings. The company is well-placed to maintain stable growth in its core food delivery business, expand its in-store, hotel and travel services as well as lower the losses in its New Initiatives segment.

Edotco Group (a tower company), which is 63% owned by Axiata, is exploring the strategic review of its business portfolio that could lead to potential spin-offs and asset sales (outside of Malaysia). Its 63%-owned tower company (Edotco Group) is also reportedly planning to raise as much as $750m in a stake sale. The shortlisted bidders reportedly include CVC Capital Partners and I Squared Capital.

SMC Global Power and its major customer, Meralco (Manila Electric) have secured an emergency power deal for a one-year supply of 300MW baseload capacity. This emergency deal will partly replace the 670MW capacity contract that has been suspended by the Court of Appeals since January 2023.

Emerging markets

The overall rally in US treasuries over the quarter helped emerging market hard currency sovereigns post a positive return of +2.25% (as measured by the JPM EMBI Global Index in US dollar terms). Emerging markets spreads were fairly resilient throughout the quarter – despite the moves in core rates – and only really began to widen during March following the collapse of SVB and the immediate risk-off move that followed. Over Q1, we saw +25bps of widening with African names faring the worst and the investment grade sub-sector outperforming high yield. We are now beginning to see signs of a reversal with some spread compression between high yield and investment grade, thanks to improved performance from high beta names.

Emerging market bond funds recorded $10.6bn worth of inflows in Q1 2023, following $89.2bn worth of outflows in 2022. The bulk of these inflows arrived in January following strong spread compression in the final stages of 2022. Q1 issuance has picked up materially for sovereigns (+$59bn vs +$97bn for full year 2022).

The major tailwind of Q1 was the re-opening of China following protracted lockdowns. This pick-up in mobility was evidenced by retail sales rising to +3.5% and industrial production increasing to +2.4%. Infrastructure investment also continued to surge, rising by 9%. We also saw stabilisation in the property sector following government support for developers. The is best illustrated by new build prices in the top 70 cities increasing for the first time since August 2021.

South America experienced significant unrest in Q1. The was evidenced by supporters of former president Bolsonaro storming the Brazilian congress, as well as a state of emergency being declared in Peru, following widespread protests.

The IMF has been active during the quarter, with Ukraine and Sri Lanka securing bailouts amounting to $15.6bn and $3bn respectively. Pakistan is also looking to secure IMF support.

Q1 also included a devastating earthquake in Turkey and Syria, killing an estimated 50,000 and causing $34bn in damage according to the world bank. Incumbent president Erdogan has faced severe criticism for lack of adequate safety measures and his response to the disaster.

Commodities

Commodity markets finished Q1 with a shock as OPEC+ announced a surprise production cut of 1.16 million barrels per day. The news sent crude prices rallying by 8%, with brent now trading at $84 a barrel. The measure was unexpected given that the decision fell outside the scheduled timeline for assessing member supply. The rationale for the cut is to pre-empt a slowdown in demand growth following signs of the tightening of credit conditions in the aftermath of SVB's failure. Goldman Sachs has now raised its December brent target to $95.

Q1 was a disappointing quarter for commodity markets with the overall index declining by 5.4%. The decline was led by energy markets, with US natural gas (the largest weight in the index) declining by a hefty 51%. This outsized decline was driven by strong US production and mild weather boosting storage levels alongside constrained export capacity following damages to the Freeport LNG export terminal. In Europe, natural gas prices declined by 36% (Dutch TTF) thanks to a milder European winter and rationing efforts, prices are now a third lower than they were before Russia's invasion of Ukraine.

Industrials metals were a mixed bag, nickel by declined 21% with the London Metal Exchange (LME) recording average daily volumes that are were down 56% y/y in February, due to the Tsingshan short squeeze breaking the market in 2022. Copper outperformed, rallying 7% YTD. Copper has been supported by themes such as the re-opening of China, civil unrest in Peru, the overhang of higher taxation on Chilean copper, and longer-term supply concerns given expectations of rising consumption.

Agricultural commodities were flat on aggregate with the major news story being the renewal of Russia/Ukraine grain corridor, which was extended by 120 days according to Ukraine and by only 60 days according to Russia.

Gold also outperformed rallying by 9% as tracked by the LMBA gold price index. Unsurprisingly, prices were supported by the risk aversion following SVB's collapse. Prices are trading near pandemic all-time highs; this is despite short term rates offering close to 5%.

Responsible investments

We're back on track with ESG labelled[1] issuance this year, with volumes following an upward trend again in Q1. Issuance somewhat stalled last year with total issuance just shy of $1 trillion. It's worth remembering we've seen almost 200% increases in issuance y/y for over a decade in this market; however last year saw a decline vs 2021 (2021 issuance totalled $1.1 trillion vs $0.9 trillion for 2022). Rapid responses were made in the wake of the covid pandemic, with specific use of proceeds bonds, in the form of social bonds, coming to the market to fund vaccine research and essential aid for those in deprived areas with lack of access to healthcare. Last year, as the world was almost fully re-opened, social bond issuance fell back in line and Green bonds stood up to become the top player again in new labelled issuance. Of the $0.25 trillion issued in Q1, over half of the labelled bond issuance YTD has been Green (57%); 13% has been Social; 19% has been Sustainable; and 11% has been Sustainability-Linked, according to data from Bloomberg.

In other news, as mentioned last week, MSCI is removing an adjustment to its fund ESG ratings, which will affect around 31,000 funds currently rated. At the end of April, based on MSCI estimates, 0.2% of all funds rated will score the AAA top rating (currently 20% score AAA). See last week's In Credit for more information on why the scores are changing.

1 – ESG labelled bonds include Green, Social, Sustainable and Sustainability-linked bonds.

Fixed Income Asset Allocation Views

3rd April 2023

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 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 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 ▪ Hiking cycles may be curtailed by weakening growth, as risk of a policy error increases	▪ 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 ▪ 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 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