COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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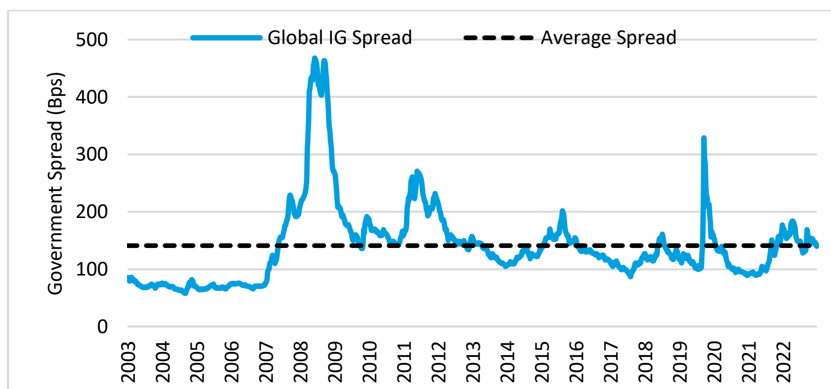
A reversion to mean.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.85%	11 bps	-1.4%	1.6%
German Bund 10 year	2.39%	3 bps	-0.3%	1.2%
UK Gilt 10 year	4.40%	8 bps	-6.0%	-3.8%
Japan 10 year	0.41%	4 bps	0.4%	2.7%
Global Investment Grade	140 bps	-3 bps	-0.1%	2.7%
Euro Investment Grade	161 bps	1 bps	0.5%	2.0%
US Investment Grade	130 bps	-5 bps	-0.2%	3.2%
UK Investment Grade	146 bps	4 bps	-3.4%	-1.1%
Asia Investment Grade	201 bps	0 bps	0.8%	3.1%
Euro High Yield	462 bps	-3 bps	1.4%	4.4%
US High Yield	405 bps	-35 bps	1.6%	5.4%
Asia High Yield	792 bps	8 bps	-3.0%	-0.2%
EM Sovereign	363 bps	-8 bps	1.5%	3.8%
EM Local	6.3%	2 bps	2.5%	7.8%
EM Corporate	344 bps	-7 bps	1.4%	3.6%
Bloomberg Barclays US Munis	3.5%	2 bps	-0.1%	2.7%
Taxable Munis	5.1%	7 bps	-0.3%	5.0%
Bloomberg Barclays US MBS	52 bps	0 bps	-0.6%	1.9%
Bloomberg Commodity Index	226.72	-0.7%	-2.6%	-7.8%
EUR	1.0886	0.1%	0.6%	1.9%
JPY	144.79	-0.4%	-7.9%	-9.1%
GBP	1.2664	-0.1%	3.0%	5.1%

Source: Bloomberg, Merrill Lynch, as of 30 June 2023.

Chart of the week: Global IG Spread to Government – last 20 years.



Source: Bloomberg, Columbia Threadneedle Investments, as of 30 June 2023.

Macro / government bonds

Yields continued to ratchet higher across the curve.

Rhetoric from central bankers reflected a hawkish mood. At a conference in Madrid, Jay Powell, chair of the US Federal Reserve argued that two further quarter point rate hikes could yet be necessary to get inflation back to its 2% target. The Fed has been successful in pushing back expectations of interest rate cuts from this year to next year, as it has talked up the need to maintain a restrictive monetary policy stance in the face of labour market tightness and a relatively resilient economy. The market continued to price in one full rate hike from the Fed for the end of the year, while marginally increasing the probability of a further rate hike by the end of the year.

Two pieces of US economic data that surprised to the upside were an upwards revision to Q1 GDP (2% versus expectations of 1.4%) and lower than expected jobless claims.

In Europe, Christine Lagarde, President of the European Central Bank, declared at the ECB Forum on Central Banking at Sintra in Portugal that the ECB will not be able to call time on its campaign to raise rates any time soon. Although headline inflation in Europe has fallen, core inflation has continued to edge higher and currently stands at 5.4%. Phillip Lane, chief economist at the ECB suggested that the market should question its assumptions on the timing and reversal of restrictive policy in the eurozone. He stated that rates are likely to remain restrictive for a sustained period to guard against any further shock, which could shift inflation away from its 2% target. Against this backdrop, the market continued to price in two further interest hikes for the eurozone for this year and five for the UK where inflation dynamics continue to disappoint.

Investment grade credit

The second quarter of the year saw a modest tightening in credit spreads and a more pronounced decline in market volatility. This came after the conditions seen in March (the mini-banking crisis). Specifically, global IG spreads started the year with a spread of 148bps widened to 170bps at one point in March – then tightened – ending June with a spread of 140bps.

For the year as a whole, the US dollar credit market spread has tightened more than the euro market with spreads compressing by 6% (euro was 4% tighter). This leaves valuations globally very close to the long run (20-year) average (141bps), but some 0.3 standard deviations cheap to a shorter-term comparison (five years): **see chart of the week**. Euro and sterling credit markets stand out on this basis as cheaper than US dollar spreads.

Industry sector wise, most sectors ended June with a tighter spread than at the end of 2022. An exception to this would be banking (around 2% wider – after the March events) and insurance, which was almost unchanged. Leading the charge tighter were media, autos and industrials.

From a valuation perspective when adjusted for risk (volatility) standout sectors are utilities, real estate, healthcare and banking, which are trading cheap to the market on a long-term horizon.

The market outlook appears fairly balanced going into the second half of the year. Corporate and banking credit quality is expected to remain strong and be supportive. Valuations, or spreads are, as mentioned, looking fairly neutral. Economic growth is expected to be low but positive into the year end, which is also a neutral factor for higher quality credit markets such as investment grade. Meanwhile, tight and tightening monetary policy remains one of the greater threats to spread compression – with interest rates above neutral in most currency blocks and expected to remain so going forward. Lastly, lengthy periods of low levels of volatility can sometimes be a harbinger of trouble ahead (eg, 2003-2006 and 2021). Not the case as yet but something to look out for.

High yield credit & leveraged loans

US high yield valuations tightened over the week as hawkish rhetoric and resilient labour market data fuel a reassessment of Fed policy expectations. The ICE BofA US HY Index returned 0.82% and spreads were 34bps tighter. According to Lipper, retail high yield bond funds saw a $730m outflow for the week, leaving YTD outflows at $11.2bn. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index rose $0.12 to $94.29, benefiting from the prospect of higher for longer Fed policy and supportive macro data. Retail loan funds saw a $195m withdrawal. YTD loan fund outflows total $18.5bn.

It was a deceptively subdued week for European High Yield (EHY) as performance was down but only by 10bps, letting the market finish just under 50bps up for the month, and almost 3% for the quarter, bringing YTD performance to 4.3%. There was more decompression as CCCs strongly underperformed the market, down almost 2% for the week, resulting in it being the only rating band with negative performance for the month and quarter. Flows were also subdued with only €23m exiting the asset class, completely due to managed accounts, as ETFs were well bid last week, experiencing positive inflows. The primary market was still relatively quiet though the pace is picking up with €1.3bn of new issuance, bringing YTD figures to €48bn. Refinancing is still the dominant reason.

There were more signs of weakness from the chemical sector with Ashland issuing a profit warning (20% cut to full year 2023 financial figures). This comes on the back of customer destocking (happening longer than expected), with problems broadening out into other areas of the business. This was in contrast to the more positive news in leisure and auto sectors, which continue to show strong sales performance (eg, Renault).

Any weakness in EHY appears to be focused on those issuers with problems more in corporate structure and having too much debt / over leveraged rather than due to a sign of macro or consumer slowdown. Even with the recent pick-up in new issuance, there remains a backdrop of limited supply, which supports the asset class.

Structured credit

The US Agency MBS market struggled alongside other interest rate sensitive asset classes. The sector was down 45bps as spreads remained relatively flat, while the bigger story was the change in student loan repayments. As part of the Debt Ceiling negotiation, the longstanding federal student loan payment pause put in place during the pandemic was set to expire this autumn. Interest was to begin accruing on 1 September this year, with borrower payments starting 30 days later. We estimate the average payment at about $300 per student, a direct hit to consumer spending, inflation and growth. On 30 June, however, the Supreme Court blocked President Biden's student debt cancellation plan, saying his administration lacked authorization under the HEROES Act to forgive up to $20,000 in student debt per borrower. Shortly after the ruling, Biden announced a 12-month "on-ramp transition period" for borrowers after bills resume. The period starts on 1 October 2023 and expires on 30 September 2024. During this period, borrowers who cannot or do not make monthly payments are not considered delinquent, reported to credit bureaus, placed in default or referred to debt collection agencies. This results in a further reprieve and likely a reduced monthly outlay for many consumers and should be supportive of overall consumer fundamentals.

Asian credit

The US Treasury Secretary Janet Yellen is reportedly planning to hold economic talks in Beijing with Vice Premier He Lifeng in early July. According to Bloomberg, the Executive Order by President Biden to expand further curbs on US investments in China could potentially be ready by late July. Currently, there are export controls on the semiconductor industry and the CHIPS Act to drive domestic investments in US semiconductor R&D and manufacturing. Beyond these existing measures, the spotlight would be on the programme that is being considered by the US Treasury Department, together with the National Security Agency, to restrict more outbound US investments in China, especially in sensitive technologies with national security ramifications. The Department of Treasury has stated that any new rules will be targeted and narrowly scoped.

Fitch has upgraded Contemporary Amperex Technology Co Ltd (CATL) from BBB+ to A- to reflect the strength of its business profile. Given CATL’s dominant market share, technological capability and capacity leadership, the company’s financial profile will remain supportive of its A- rating although FCF will trend towards neutral by 2024 due to its high capex cycle.

The Adani family has sold an additional 1.58% stake in Adani Enterprises Ltd (AEL) and a 2.9% stake in Adani Green Energy Ltd (AGEL) for around $1bn to GQG Partners and other investors. Both AEL and AGEL also recently secured the approvals from their respective boards to raise an additional INR210bn through share placements to institutional investors by way of QIP (qualified institutional placements).

In Hong Kong, Chow Tai Fook Enterprises (CTFE) announced an offer to buy out existing shareholders of NWS holdings, including around 61% of shares held by New World Development (NWD). CTFE currently held 45% in NWD and less than 3% in NWS. NWS is the infrastructure and services division of NWD. Both NWD and NWS have US dollar notes outstanding. For NWS, the privatization will not trigger Change of Control. After the privatization, NWS is likely to increase dividend pay-outs and benefit from stronger parent support by CTFE. The impact on NWD is positive in the short-term with HKD17.8 bn net proceeds from the disposal. However, in the longer run it could be credit negative, given no more recurring income contributed by NWS.

Emerging markets

Emerging market hard currency sovereigns ended the quarter with a positive return of +1.88%. Whilst the move higher in US treasury yields was negative for the asset class, emerging market spreads tightened 36bps, with the majority of the tightening coming from high beta names as we saw a significant spread compression theme between high yield and investment grade.

In ratings news, Colombia was affirmed at BB+ by Fitch with outlook stable last week. The central bank also opted to hold interest rates at 13.25%.

On the distressed debt front, Sri Lanka's parliament approved a domestic debt restructuring plan, a crucial measure as part of the recently agreed $2.9bn IMF bailout. The government also proposed a restructuring plan for international bond holders, consisting of a 30% haircut on $12.5bn worth of dollar bonds. Bondholders can also opt for a 0% haircut in exchange for a 15-year maturity extension at 1.5% interest. Elsewhere, Pakistan secured a staff level agreement for a $3bn IMF bailout programme.

Commodities

The commodity index declined by -0.7% on the week with modest strength in the energy complex (+1.3%) being offset by weakness in agriculture (-4.4%) and industrial metals (-1.3%).

In energy, WTI rallied by 2.1%, closing the week at $71. Prices were supported by the department of energy purchasing 3.2m barrels of crude to refill the strategic petroleum reserve (SPR). The SPR currently has low inventory levels after releasing over 220m barrels in 2022 to alleviate the energy crisis.

Elsewhere, US oil production costs fell by 1%, the first decline in three years. Goldman Sachs said this implies further downside risk to its crude price target (WTI), which was recently downgraded to $81 from $89.

In agricultural markets, corn prices dropped by 16.5% to their lowest level in 30 months. This follows the USDA's acreage report showing corn planting beating expectations and rising by 6.2% YoY. Acreage levels were supported by recent dry conditions leading to a speedy planting season and allowing farmers to replace failed wheat crops with corn.

Responsible investments

We finished June with volumes of 'labelled bond' issuance not seen since the end of 2021, with the YTD total well over $0.5trn, according to Bloomberg. This is primarily attributable to green bond issuance, as we have noted in previous publications, followed by social bonds and sustainability bonds. Deeper analysis and criticism have caused issuance of sustainability-linked bonds to fall (down 28% YTD) and become far less popular.

Fixed Income Asset Allocation Views

3rd 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 leans negative on Credit risk overall favouring higher quality sectors.** ■ The Fed Funds market is pricing in a peak of 5.3% and rates being cut to 5.0% in 2023. This market has been volatile, with the first full cut now priced for Nov. ■ The CTI Global Rates base case view is no cuts in 2023, and possibly one more hike during the summer. Expect the Fed to hold steady in 2H 2023. Focus remains on wages, financial conditions, and inflation expectations. ■ Uncertainty remains elevated due to fears surrounding banking crisis spill over, 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 beginning to tighten from March wides.. Technicals remain weak ■ Maintaining conservative positioning while open to select idiosyncratic or relval based buying opportunities. ■ Tailwinds: Central bank easing in less inflationary countries. ■ Headwinds: higher debt to GDP ratios, wider fiscal deficits, increasing use of IMF programs, geopolitical risks, domestic political uncertainty.	■ China/US relations deteriorate; China reopening less stimulating than hoped. ■ Issuance slows ■ Chinese reopening paused ■ 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 spreads have tightened & EMEA spreads unchanged since last month; Fundamentals and Technicals still weak to pre-COVID. EUR valuations are cheap, prefer USD and Euro to Sterling ■ May issuance mostly in longer end of curve. Earnings resilience with deteriorating credit metrics point to idiosyncratic opportunities. Fundamental concerns remain focused on commercial real estate for Banking sector, tight labour supply, weaker consumer, recession concerns.	■ Additional bank failures with too little governmental intervention ■ Volatility remains high and 2023 supply isbelowexpectations. ■ 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 tightened since early May, fundamentals and technical remain unchanged, with beginning of June reversing May outflows. ■ 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	■ Additional bank failures with too little governmental intervention. ■ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks ■ Rally in distressed credits, leads to relative underperformance
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ Mortgage index remain wide to historic levels, the group sought to capitalise on Mya's weakness. ■ Supply below expectations but improving. FDIC liquidations from Banks nearly half done. ■ Place to add, prefer high quality and higher coupon assets; constructive view over longer time horizon	■ Additional bank failures ■ 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
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 remain 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 ■ CLOs: Spreads have widened slightly since May. Downgrades outpacing upgrades. More tail risks for subordinate bonds ■ 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 ■ WFH continues in 2023 (positive for RMBS, negative for CMBS). ■ Rising interest rates dent housing market strength and turn home prices negative in 2023 ■ 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 Soybeans ■ o/w Oil ■ u/w Silver ■ o/w Wheat ■ o/w Corn	■ Global Recession

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