

In Credit

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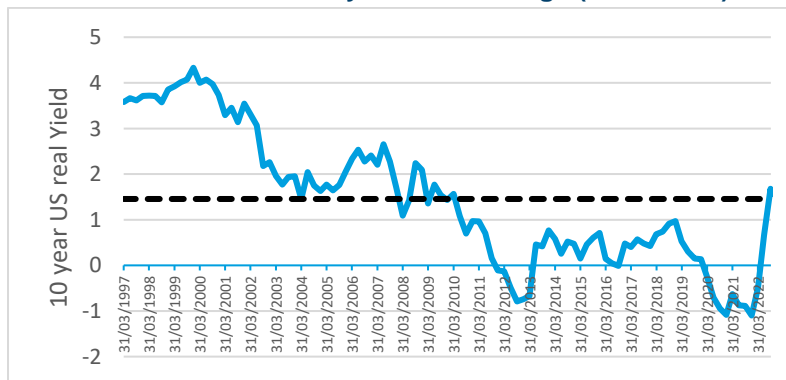
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Emerging Markets

Real yield normalisation. Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.61%	-7 bps	-4.7%	-13.5%
German Bund 10 year	1.92%	-11 bps	-4.7%	-15.4%
UK Gilt 10 year	3.97%	14 bps	-13.6%	-26.3%
Japan 10 year	0.25%	1 bps	1.4%	-3.6%
Global Investment Grade	180 bps	18 bps	-4.6%	-17.0%
Euro Investment Grade	221 bps	23 bps	-3.3%	-15.1%
US Investment Grade	167 bps	16 bps	-5.1%	-18.3%
UK Investment Grade	195 bps	34 bps	-11.6%	-22.6%
Asia Investment Grade	232 bps	26 bps	-3.0%	-11.0%
Euro High Yield	640 bps	74 bps	-0.7%	-15.7%
US High Yield	543 bps	31 bps	-0.7%	-14.6%
Asia High Yield	1025 bps	78 bps	-4.8%	-23.1%
EM Sovereign	467 bps	32 bps	-4.2%	-22.2%
EM Local	7.3%	18 bps	-4.7%	-18.6%
EM Corporate	404 bps	27 bps	-2.6%	-16.2%
Bloomberg Barclays US Munis Taxable Munis	4.0%	17 bps	-3.5%	-12.1%
	5.2%	16 bps	-7.3%	-22.2%
Bloomberg Barclays US MBS	69 bps	-1 bps	-5.3%	-13.7%
Bloomberg Commodity Index	242.08	-0.7%	-4.1%	13.6%
EUR	0.9809	1.2%	-6.5%	-13.8%
JPY	144.47	-1.0%	-6.2%	-20.5%
GBP	1.1280	2.9%	-8.3%	-17.5%

Source: Bloomberg, Merrill Lynch, as at 30 September 2022.

Chart of the week: US real yield and average (1997- 2022)



Source: Bloomberg Columbia Threadneedle Investments, as at 1 October 2022.

Macro / government bonds

It was a week where Vladimir Putin laid claim to lands that are not his own, the Nordstream gas pipeline seemed to have been sabotaged and a reckless British government was bailed out by its own central bank in a bid to support a section of the UK pension fund industry. Meanwhile, data from the US showed ongoing strength and inflation reached double digit rates of growth in Germany – the first time in 70 years. Seven days is a long time in asset management.

As the dust settled, and the month came to an end, what are we left with? Yields are much higher; yield curves are flatter, and markets are lower across the board. Yet again the reason is this – the discount rate is rising. Future cash flows are worth less and so markets are lower. As we have mentioned, the total return numbers are at a record negative for this year ([see Markets at a glance](#)).

There is good news. If history is any indicator of perspective, the US 10-year real yield is now above the long-term average and at 1.6%, which seems sensible ([see Chart of the week](#)). Ageing populations need income and now they can have it. Yields on government bonds, investment grade and high yield credit seem appealing and emerging markets are also attractive. Time to buy? We can never be sure; but you might think twice about being short of bond markets at these levels.

This week brings the monthly employment report in the US, which is expected to see lower levels of job creation than last month. In the US, the Manufacturing PMI also comes out this week.

Investment grade credit

Credit markets had a poor week and another bad month in a very weak year.

Globally, credit spreads ended the week (and the month) at the widest level of the year (180bps). Again, euro denominated credit has underperformed as have shorter dated bonds as credit curves have flattened. The euro market is now around 126% wider in spreads this year with shorter dated bonds (1-5 year) were wider still by 154%. In the US spreads are 'only' wider by 70% in 2022 though shorter dated bonds are wider 111%

The outlook is blemished by expectations of ongoing contractionary monetary policy conditions. Meanwhile, consensus expectations for economic growth teeter on the brink of recession for 2023; albeit expected to improve modestly into 2024. Clearly given what was discussed earlier valuations (spreads) are much better than was the case earlier in year. Compared to short- and longer-term averages, euro credit stands out as the cheapest market and is 3.5 standard deviations (SDs) wide of the five-year average and 1.3 SDs wide of the 20-year norm. The US market is wider than average but by a lower margin. We expect credit quality to improve modestly in the US and vice versa in the eurozone. We note periods of high volatility and challenged liquidity were good entry points to the market post GFC and in late Spring of 2020.

High yield credit & leveraged loans

US high yield bond spreads widened the most since early July over the past week amid intervention by the BoE, a chorus of hawkish Fed officials, and a fresh 15-year high in US treasury volatility. The ICE BofA US HY CP Constrained Index returned -1.35% and spreads were 31bps wider. According to Lipper, the asset class reported a \$3.0bn outflow, leaving YTD

outflows at \$54bn. Leveraged loan prices, referencing the J.P. Morgan Leveraged Loan Index, declined \$1.37 over the week to \$91.92 as recession concerns continue to outweigh the benefits of rising rates. The leveraged loan mutual fund base also endured its second largest outflow of 2022, -\$1.9bn, with the past six weeks' exodus totaling -\$6.9bn, leaving YTD net flows at \$1.9bn.

European High Yield (EHY) experienced quite a bit of repricing last week between spreads and lower rated credit. There was greater performance dispersion than has been seen in a while, with CCCs heavily underperforming Bs and BBs. Spreads are starting to catch up with the rate move higher as this week's negative performance was all due to spread widening as yields rose by the same amount (+74bps to 8.67%) as the increase in spreads (back to 640bps).

September is now the third worst performing month in 2022 for EHY though the third quarter's negative performance was less than 1% given July's strong performance. Fund outflows increased with €480m out last week, via both ETFs and managed accounts, taking the YTD figure to -€11.5bn. The primary market was mixed. There was one new issue by Verisure, the security company (B1 rated) which came with a €500m bond at 9.25% for a five-year bond, while a number of other proposed deals were shelved given the market volatility and higher price demanded by investors. STG high yield bonds were especially illiquid with many market makers shying away from pricing anything STG based.

In credit rating news, S&P upgraded Europcar to B flat (from B-), with outlook stable based on the VW 66% ownership and expectation of better than assumed results in FY22, even though weaker 2023 figures are also expected. Good news for Darling (US based animal product and cooking oil recycler to renewal diesel) as Moody's upgrade it to Ba1 from Ba2. Not great news for Mahle, though, as Moody's moved its rating from Ba1 to Ba2, negative, citing weak margins and elevated leverage given the firm's challenges in passing on higher RM and energy costs.

In sector news: in chemicals, Avient and Synthomer became the latest chemical companies with earnings warnings as the firms reported weaker customer demand as well as unfavourable FX. Retail also took a hit with NEXT, the apparel store chain, cutting guidance given the inflation hit on consumers. In contrast, leisure sector continued to show strong numbers with Accor hotels upping their EBITDA outlook for FY22, beating consensus.

Structured credit

The US Agency MBS market faced more volatility last week and posted a negative return of -69bps. In data releases, the FHFA House Price Index came in weaker than expected with all regions, save one, down and the S&P Core Logic Home Price Index was also down.

Contrastingly, new home sales came in at the strongest level since March as buyers raced to beat rate hikes and take advantage of builder incentives. Pending home sales, however, posted the seventh month of consecutive decline and the lowest level since 2011. Given the rate move, 15-year agency MBS outperformed 30-year and higher coupon/lower duration bonds also outperformed. 30-year coupon spreads ended the week 6bps wider, which is closing in on levels not seen since March 2020. While it's hard to argue many of the headwinds: less support from the Fed, albeit not outright selling; consumer inflationary pressure and affordability at historically low levels; there is a lot of bad news in the price right now.

In secondary non-agency RMBS, spreads widened across most sectors and new issue deals struggled to clear. In CMBS, spreads once again widened on the week as secondary supply swelled on money manager outflows. Floating rate AAA paper bore the brunt of the widening.

Demand from yield buyers is helping fixed rate conduit AAA spreads outperform. Supply was also to blame with conduit new issue at 2x the weekly average.

Asian credit

The Indian Ministry of Power has rejected a proposal for Power Grid to acquire a controlling stake in REC Ltd from Power Finance. Accordingly, REC Ltd will continue to operate as a 52.6%-owned subsidiary of Power Grid. Brookfield Asset Management is reportedly interested to invest at least \$1bn in Greenko Energy Holdings (GEH). The current major shareholders of GEH are GIC Private Ltd (56%), ORIX Japan (22%), Abu Dhabi Investment Authority (ADIA, 14%) and the founders (8%).

In China, the preliminary numbers from CRIC (China Real Estate Information Corp) show that the September 2022 contracted home sales continue to be weak. According to CRIC, the largest 100 property developers saw their September new home sales declined by 25.4% y/y to CNY571bn (c\$80bn), albeit on a m/m basis, sales rose 10%. The state-owned property developers, however, performed relatively better than the privately owned companies. Certain state-owned property developers (China Resources, China Merchants, Greenland, Yuexi) reported sales volume growth of more than 35% m/m .

There are several new regulatory measures to support the demand for new homes.

The government will allow certain cities to implement the reduction of mortgage rates for first-time homebuyers. This is applicable for cities which saw y/y or m/m declines in new home prices during June-August.

The Ministry of Finance and the State Administration of Taxation also announced tax rebates (effective from 1 October 2022 to end-2023) on profits of home sales for qualified residents within the same city, who buy new homes within a year of selling their previous home. Specifically, the individual income tax that residents had paid upon selling their old homes, will be fully refunded if the price of their newly purchases home exceeds that of their old homes within the same city. This tax measure is targeted to encourage home upgraders to buy new homes.

The PBOC also announced that the HPF (housing provident fund) mortgage rate will be lowered by 15bps, effective on 1 October 2022: mortgages under 5y (2.6%) and mortgages > 5y (3.2%).

Additionally, the PBOC and CBRIC (China Banking and Insurance Regulatory Commission) told the six largest banks to extend at least CNY600bn (or \$85bn) of net financing to the property sector for the final four months of 2022.

Emerging markets

Heightened global market volatility resulted in a negative return of -2.72% for the JPM EMBI Global Index over the week. Spreads were 32bps wider with significant widening coming from African names.

First round presidential elections took place in Brazil: the former left-wing president Lula won with 48%; however, the current president, Bolsonaro polled better than expected, achieving 43% of the vote. The second round will take place at the end of the month and is expected to be tightly fought, opening the possibility of contested elections.

Ghana was downgraded by Moody's one notch to Caa1 and placed it on negative outlook due to macroeconomic deterioration. Tunisia was also put on negative outlook by Moody's. S&P cut

Turkey to B as inflation hit 83.5% and President Erdogan called for rates to be cut to 10% by year end (from 12% currently). There were rates hikes elsewhere in emerging markets over the week; Mexico hiked in line with expectations, +75bps to 9.25%. Colombia raised rates 1% to 10% and in Europe Hungary hiked more than expected to 13%. The Hungarian Forint has been the worst performing EM currency YTD on a total return basis.

Ukrainian forces launched a counter offensive further into the Donbas region capturing the city of Lyman. The victory follows Russia declaring the annexation of Donetsk, Luhansk, Kherson and Zaporizhzhia (which it does not full control), in what is widely regarded as a farce referendum. Reports suggest Russia's recent mobilisation of 300,000 reservists is causing fear and anxiety within the Russian population alongside an exodus of men from Russia.

Commodities

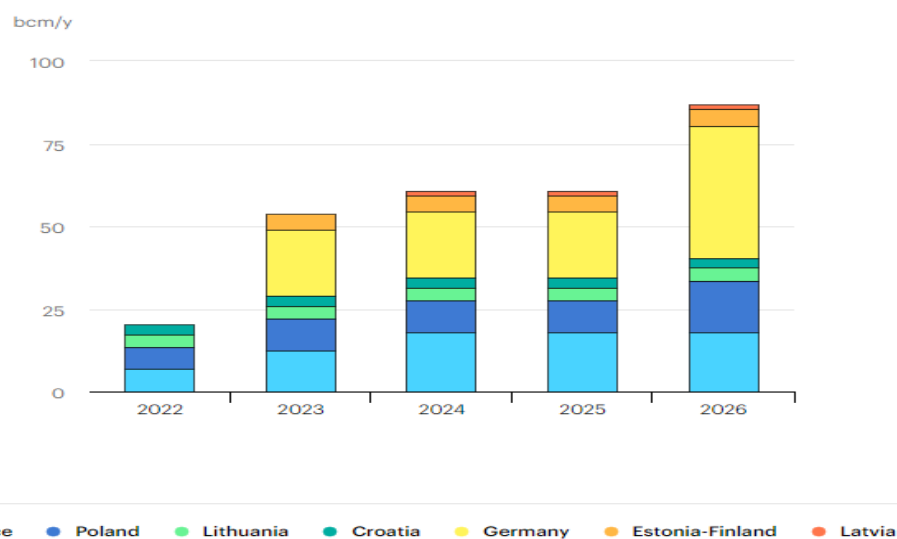
The BCOM index saw a modest decline of -0.7% on the week as macro headwinds continued to hit risk assets. Industrial metals were one of the weakest performers with nickel declining 9.9% over the week. Prices have been hit by a combination of position sales from banks in response to rising borrowing costs, surging Indonesian production and demand concerns due to energy supply.

European natural gas prices eased by 8.8% as storage facilities in Germany reached 91% capacity. The longer-term demand outlook has also weighed on prices; the IEA expects European gas consumption to fall by 4% in 2023 and 10% in 2022.

The need to replace Russian gas has caused European nations to turn to LNG and floating liquefied natural gas terminals in the short term. These terminals are cheaper and quicker to set up than the onshore gasification units that Germany is looking to build but, unfortunately, they are currently facing shortages and spiking rental rates. Europe's expected LNG import push is articulated in the chart by the IEA below.

Second 'Chart of the week'

Liquefied natural gas import capacity in central and eastern Europe 2022-2026



Source: IEA as at 26 September 2022.

Summary of fixed income asset allocation views (as at 3 October 2022)

Fixed Income Asset Allocation Views

3rd October 2022



Strategy and positioning (relative to risk free rate)	Views	Risks to our views
Overall Fixed Income Spread Risk 	<ul style="list-style-type: none"> Credit spreads have widened since the last meeting with volatility still high and a market-wide softening in technicals and fundamentals. This has kept the group negative on credit risk with no changes to sector outlooks. We are past the peak of economic growth with first few hikes done and expectations for more 75-100bp hikes through the end of 2022. Pullback in liquidity created opportunity for market volatility. Uncertainty remains elevated due to fears surrounding pace of central bank hiking, inflation, recession probabilities, weakening consumer profile and the Russian invasion of Ukraine. 	<ul style="list-style-type: none"> Upside risks: the Fed achieves a soft landing, Europe sees commodity pressure easing, consumer retains strength Downside risks: simultaneous low unemployment, high inflation, hiking, and slowing growth cause a recession. Russian invasion spills into broader global/ China turmoil. New Covid variants. Supply chain disruptions, inflation, commodity shocks persists to Q4 2022.
Duration (10-year) (P' = Periphery) 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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) 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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)) 	<ul style="list-style-type: none"> Substantial monetary policy tightening now embedded into EM local rates Aggressive Fed pricing may now open the door to selective EMFX performance EM real interest rates relatively attractive, curves steep in places 	<ul style="list-style-type: none"> Negative sentiment shock to EM fund flows Central banks tighten aggressively to counter fx weakness EM inflation resurgence EM funding crises drive curves higher and steeper Tightening global financing conditions
Emerging Markets Sovereign Credit (USD denominated) 	<ul style="list-style-type: none"> EMD spreads unchanged from August; still seeing bifurcation in market with value in BBB and BB names Fundamental headwinds: elevated fiscal deficits, rising debt to GDP ratios, significant inflation, central bank tightening, China lockdown/growth, idiosyncratic political risks, increasing use of IMF programs Recent commodity price retracement has supported some names under pressure (India & Turkey); China real estate remains challenged with weaker data and growth forecast Technicals (outflows and supply) remain a headwind 	<ul style="list-style-type: none"> Chinese growth derails with less stimulus and uncertain zero covid policy after economy reopens 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 	<ul style="list-style-type: none"> US & EMEA spreads have widened since August. Stable fundamentals beat pessimistic expectations for Q2 earnings. Inflation, labor supply, low dispersion and monetary tightening remain headwinds pressuring margins and operating environment in 2H 2022 Technicals have continued to struggle with slow issuance, negative fund flows and poor liquidity 	<ul style="list-style-type: none"> Companies release materially lower Q4 outlook revisions Market indigestion as central banks sell EMEA corporates Rate environment remains volatile Russian invasion worsens operating environment globally
High Yield Bonds and Bank Loans 	<ul style="list-style-type: none"> Spreads have widened since August. Combined with greater downside risks, the group prefers conservative position while open to attractive buying opportunities. Technicals remains a headwind with light primary issuance, however August US fund flows were positive and default activity remains benign/idiosyncratic Bank loan market has moved lower with fewer new issues and low secondary trading volumes; concerns about recession and interest cost remain headwinds 	<ul style="list-style-type: none"> Default concerns are focused on demand destruction, margin pressure and macro risks Loan technicals & flows weaken Russian invasion & spillover rattles US bond loan/market as already seen in EMEA Commodity prices continue to retrace
Agency MBS 	<ul style="list-style-type: none"> Mortgages spreads have widened in the past month in sympathy with risk assets, supply continues to drop along with purchase activity and cash out refinancing Current coupon spreads near recent wides Headwinds as the Fed is reducing balance sheet position and bank demand has cooled as deposit growth slows 	<ul style="list-style-type: none"> Housing activity slows and rising rates move prepaids to normal levels without hurting mortgage servicing rates. Uncertainty with the Fed hiking and future balance sheet position
Structured Credit Non-Agency MBS & CMBS 	<ul style="list-style-type: none"> Our preference remains for Non-Agency RMBS RMBS: Increase in mortgage rate creates headwinds for prepaids and fundamentals. Delinquency performance remains strong, but housing is slowing. Reducing risk CMBS: Mostly solid fundamentals but weakening. Spreads flat MoM. Better relief in other sectors, continue to trim. CLOs: Default rate low but increasing, AAA spreads stable, supported by overseas investing. Mezz spreads worse as BB's 100 wider and manager tiering increasing ABS: Lower income, renters, lower fico borrowers continue to underperform. Higher quality borrowers' performance remains with expectations. Reducing exposure to inflation-sensitive borrowers 	<ul style="list-style-type: none"> Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening, consumer retail/travel behavior fails to return to pre-covid levels Work From Home continues full steam-ahead post-pandemic (positive for RMBS, negative for CMBS). SOFR deals slows CLO new issue Rising interest rates dent housing market strength
Commodities 	<ul style="list-style-type: none"> o/w Copper & Lead vs Zinc o/w Softs o/w Grains u/w Gold o/w Oil u/w Silver 	<ul style="list-style-type: none"> Global Recession



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