

In Credit

4 September 2023



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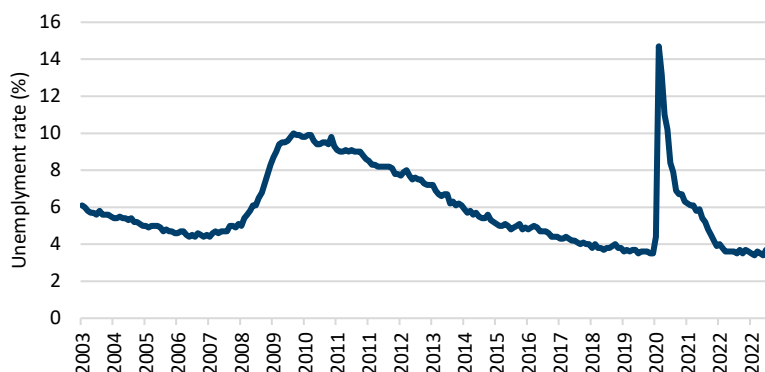
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Rising unemployment ...at last. Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	4.18%	-6 bps	-1.4%	0.2%
German Bund 10 year	2.56%	0 bps	-0.5%	0.7%
UK Gilt 10 year	4.44%	-1 bps	-0.2%	-4.0%
Japan 10 year	0.64%	-2 bps	-2.2%	0.5%
Global Investment Grade	133 bps	0 bps	-0.18%	2.55%
Euro Investment Grade	154 bps	1 bps	1.0%	3.0%
US Investment Grade	122 bps	-1 bps	-0.8%	2.4%
UK Investment Grade	132 bps	-1 bps	1.9%	0.8%
Asia Investment Grade	209 bps	6 bps	0.1%	3.2%
Euro High Yield	467 bps	-2 bps	1.45%	5.90%
US High Yield	381 bps	-9 bps	1.7%	7.2%
Asia High Yield	962 bps	-37 bps	-4.4%	-4.6%
EM Sovereign	349 bps	-3 bps	0.0%	3.8%
EM Local	6.4%	-4 bps	-0.1%	7.7%
EM Corporate	334 bps	0 bps	0.5%	4.1%
Bloomberg Barclays US Munis	3.8%	-4 bps	-1.1%	1.6%
Taxable Munis	5.3%	-7 bps	-2.0%	3.0%
Bloomberg Barclays US MBS	54 bps	-3 bps	-1.4%	0.5%
Bloomberg Commodity Index	240.69	1.3%	6.1%	-2.1%
EUR	1.0804	-0.1%	-1.2%	0.7%
JPY	146.34	0.1%	-1.3%	-10.3%
GBP	1.2638	0.1%	-0.9%	4.2%

Source: Bloomberg, Merrill Lynch, as of 1 September 2023.

Chart of the week – US unemployment rate, 2013-2023



Source: Bloomberg, Columbia Threadneedle Investments, as of 4 September 2023.

Macro / government bonds

Friday gave us another Non-Farm Payroll (NFP) day, triggering speculation that the US Federal Reserve may have done just enough to dampen demand without triggering a recession.

The NFP came in at 187k for August while the data for the prior month was revised down 30k from 187k to 157k. The trend in the labour market data suggests we are in softer territory with job creation averaging 271k over the prior 12-month period.

Labour market tightness, and the role that higher wage settlements have played in underpinning inflationary pressures, means no market participant can be sure that central banks can take their foot off the monetary policy pedal until there is certainty the labour market is weakening. Although NFP reported continued job creation across industry sectors, the rate of job growth clearly moderated. The number of unemployed (both recently and longer-term unemployed) rose by 0.3% to 3.8% while the labour force participation rate also edged higher. The NFP number echoed that of ADP, which reported a rise in employment of 177k for August. Although widely regarded as offering less informational value than NFP, ADP reported a similar trend of slowing job creation. US labour data could be made to fit a narrative of deteriorating demand.

However, US treasury yields actually rose in the hours following the publication of the NFP report. This reflected a higher reading from the ISM manufacturing survey, which rose from 46.4 to 47.6 while the ISM Prices Paid Index (a measure of inflation) rose from 42.6 to 48.4. Over the course of the week, US treasury yields at the 10-year maturity point oscillated within a 10 bps range of 4.2%. The sensitivity of the market to incoming data reveals just how finely balanced it is to the competing narratives of “slowing growth” and “higher rates for longer.” These forces have helped keep the US treasury market range bound, as we continue to edge towards terminal rate levels.

One technical factor to exert upward pressure on the US treasury market has been the level of treasury issuance and upcoming US corporate issuance. In the eurozone, there was minimal movement in bond yields over the week. One intervention that did garner market attention was a speech by European Central Bank policymaker, Isabel Schnabel, widely regarded as being on the hawkish wing of rate setters, in which she recognised the dire growth prospects of the eurozone. Pricing in the swaps market for September indicated zero expectations of a rate hike by the US Fed and around a 30% probability of a rate hike by the ECB.

Investment grade credit

Compared to the volatility in government bond markets, credit markets have been relatively calm.

The global corporate bond market closed last week with a spread of 133bps over government bond yields according to data from ICE indices. This was wider than at the end of August (128bps) but little changed over the last week. US markets have outperformed this year with a 12% tightening in spreads. For comparison euro-denominated spreads are only 8% tighter. Globally the media, auto and industrial sectors have led the tightening while banking (post Credit Suisse and SVB), insurance and telecoms have lagged – albeit all still tighter this year.

This week begins with a US holiday on Monday. Following this we can expect a high level of new issuance especially in the US where supply has been light recently.

High yield credit & leveraged loans

The European High Yield (EHY) market gave up some in yield and spread during the August summer recess as the former rose 8bps to 7.76%, while the latter widened 14bps to 469bps but still returned +25bps. This brings the YTD return to 5.9%. August saw further decompression as CCCs spreads widened sharply more than higher-rated credits, but the rating band still outperformed BBs and Bs given CCC's yield level of almost 20%. Flows were net negative for August with some €600m exiting via both ETFs and managed accounts, though the greater amount was via the latter. The primary market was largely shut in August with only one corporate deal at the end of August, which was Telefonica's €750m new issue. It is expected

that the market will open in September with 11 planned deals waiting in the wings, largely higher-rated credits with a focus on refinancings.

It is challenging times for higher beta credits to refinance given the double digit yields levels demanded in the EHY market. Alternative means for raising financing are being increasingly explored. Last week Intralot, a CCC-rated Greek gaming company, announced the refinancing of its September 2024 bond with a combination of rights issue, syndicated loan and retail bond to be issued in Greece.

There was more good news from the auto sector. Volvo August car sales were up 18% showing the ongoing improvement in auto sales as supply chains ease and consumer demand stays relatively resilient, with big support from the EV section of the business as sales were +167%.

Asian credit

The Stock Exchange Board of India (SEBI) has filed a status report about its investigation into the Adani group to the Supreme Court on 25 August. According to the Adani Group, out of the 25 allegations the SEBI has investigated, there are 22 allegations that have been finalized and two which are interim in nature. The Supreme Court postponed the hearing originally scheduled on 29 August and no further dates were announced. There are no additional details about the outcome of SEBI's probe and the extent of any regulatory violations and penalties.

Country Garden reported a net loss of CNY49bn in H123, with an impairment of CNY40bn, representing 4.5% of book value. Its home delivery business remains on track and H123 revenue rose 39% y/y. That said, the company has been facing liquidity pressure due to the difficult refinancing environment. Specifically, Country Garden reported a 0.9x cash to ST debt ratio, with CNY101bn of cash at H123, falling below the amount of ST debt (CNY109bn). Following the coupon payment miss on its US dollar bonds, Country Garden has a 30-day grace period (till 6 September 2023) to make the payment.

Emerging markets

Emerging market hard currency sovereign bonds posted a positive return of 0.67% over the week thanks to a decline in US treasury yields as EM spreads were broadly unchanged. The investment grade sub-sector outperformed high yield.

A coup emerged in Gabon during the week with President Ali Bongo being placed under house arrest following the announcement of re-election. His family has held power for over 50 years. This follows a recent coup in Niger and is the eighth coup in west and central Africa since 2020.

Former Pakistan Prime Minister Imran Khan had his conviction suspended but remains in jail. Previously imprisoned on corruption charges, he is now fighting accusations that he disclosed official secrets. Khan hopes to run for election early next year and is viewed as having a strong chance of victory, but legal battles and prison time mean those chances are fading.

There was little central bank action over the week with policy makers in Hungary continuing to hold interest rates at 13%. Polish CPI came in at 10.1%, which was slightly higher than expected: nevertheless it looks likely that Poland's central bank will commence rate cutting next week when it meets.

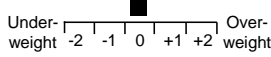
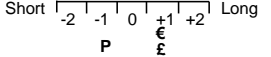
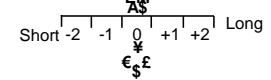
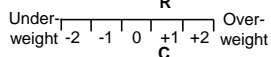
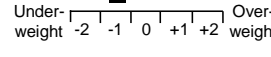
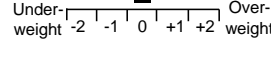
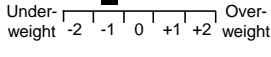
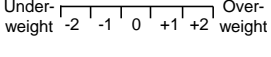
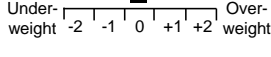
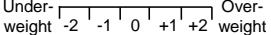
Responsible Investments

Issuance of ESG bonds has picked up markedly recently, predominantly with green bonds. YTD issuance is now over \$650bn and up 7.5% on this time last year, according to Bloomberg. Corporates such as Amprion, Volkswagen, Telefonica and Engie and financials such as Swedbank, Citibank and Credit Agricole have all issued in the last week. Volkswagen's \$750m perpetual bond issue is the latest in its ring-fenced financing towards clean transportation with its EV development. The UK DMO could soon issue its next tranche of Green Gilts with £10bn on the potential deals list, along with Brazil who is said to be considering its debut into the ESG bond market this month.



Fixed Income Asset Allocation Views

4th September 2023

Strategy and positioning (relative to risk free rate)	Views	Risks to our views
Overall Fixed Income Spread Risk 	<ul style="list-style-type: none"> Valuations have continued to tighten, some sectors their richest in over a year. Technicals seem stable; fundamentals show modest pockets of weakness, but no thematic deterioration. The Group stands neutral on Credit risk overall favouring higher quality credit. The CTI Global Rates base case view is no cuts in 2023, with one more hike before holding to end the year. Focus remains on wages, labor market, financial conditions, and inflation expectations. Uncertainty remains elevated due to stricter lending, monetary policy tightening, persisting inflation, weakening consumer profile and ongoing geopolitical tension. 	<ul style="list-style-type: none"> Upside risks: the Fed achieves a soft landing with no labour softening, no lasting changes to fundamentals following banking crisis, consumer retains strength, end of Russian Invasion of Ukraine Downside risks: Rising unemployment, especially if wage growth remains high and the Fed continues hiking. Supply chain disruptions, inflation, volatility, commodity shocks reemerge.
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 	<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"> 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 	<ul style="list-style-type: none"> 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)) 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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) 	<ul style="list-style-type: none"> EMD spreads have widened in the last couple of weeks, however technical still remain balanced with limited supply over the last couple of months. Conservatively positioned with fewer idiosyncratic opportunities after market compression, 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. 	<ul style="list-style-type: none"> China/US relations deteriorate; China property sector challenges not contained 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 	<ul style="list-style-type: none"> US and EMEA spreads have tightened since last month; with fundamentals showing resilience, minor exceptions in consumer facing names and some energy and utilities. EUR valuations are cheap, prefer USD and Euro to Sterling. YTD net issuance greater than last year, and expected to pick up in 2H23. Confidence from credit metrics amidst recession uncertainty. Fundamental concerns remain focused on commercial real estate for Banking sector, tight labour supply, weaker consumer, recession concerns. 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> Spreads continue to tightening with valuations inside historic medians. Technicals strong and stable, fundamentals still solid but beginning to show small pockets of weakness. Prefer conservative position while open to attractive buying opportunities, especially in short HY & BB's and higher quality loans where increased financing costs are less of a headwind. US HY defaults higher than last year but still at reasonable levels, possibly normalising to historic trends. Bank loan market continuing May's rally, with overall market dispersion. Themes: retail fund outflows, delayed defaults, limited issuance, increasing interest burden, credit concern in lower quality loans. 	<ul style="list-style-type: none"> 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 Pockets of weakness improve, HY spreads show resistance to widening that typically follow tightening policy.
Agency MBS 	<ul style="list-style-type: none"> Mortgage index unchanged or slightly wider than last month with spreads wide of historic medians, the group views agencies as opportunistic. 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 	<ul style="list-style-type: none"> Costlier funding and tighter lending standards from bank crisis Housing activity slows and rising rates move prepaids to normal levels without hurting mortgage servicing rates Fed continues to shrink position Market volatility erodes value from carrying
Structured Credit Non-Agency MBS & CMBS 	<ul style="list-style-type: none"> 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. 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. CLOs: Continued modest tightening. Downgrades outpacing upgrades. Prefer new issues, but supply is low. ABS: Attractive reval in some senior positions; higher quality borrowers remain stable. Market is activewith decent valuations. 	<ul style="list-style-type: none"> 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 turn home prices negative, denting housing market strength. Cross sector contagion from CRE weakness.
Commodities 	<ul style="list-style-type: none"> o/w Copper o/w Grains u/w Gold o/w Soybean Meal o/w Oil o/w Lead 	<ul style="list-style-type: none"> Global Recession



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